POLISH "SENSITIVE SECTORS"

PRIVATIZATION STRATEGIES

STEEL INDUSTRY

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PREFACE: Purpose, scope and limitations of this report

The Bancroft Group was awarded a Task Order by USAID in April, 1996 to outline privatization strategies for five "sensitive sectors" in the Polish economy i.e. shipbuilding, mining, steel, non-ferrous metals and chemicals. Each of these sectors is characterized by limited privatization to date and excessive relative employment. Significant capital needs reflecting modernization requirements to improve cost efficiencies and quality of output are also generally required.

The Task Order was signed on August 1, 1996, but most Ministry officials were on vacation. The official sponsor of the project, Mrs Ewa Freyberg, former Deputy Minister of Ownership Changes requested a special meeting with _ucja Cannon, the project manager, which took place on 30 August 1996. Details of the project were discussed and it was decided to give a greater emphasis to issues of international competitiveness. At that time it was also agreed that the team would limit its work to examining the steel sector and two components of the chemicals sector. It was agreed that the team would arrive in Warsaw on September 15, 1996.

On the way to Warsaw, the team engaged in independent investment research in the identified steel and chemicals sectors in order to advance its knowledge and ability to make recommendations in these sectors. Materials were gathered by _ucja Cannon in the United States, and by the team in London consultations with investment research representatives of investment banks and with representatives of the EBRD.

Upon arrival, the team discovered that security clearances were required by the Polish government for access to reports and relevant government personnel needed to execute the Task Order. Such reports originally were identified as the sole source of information necessary for the Task Order to be implemented. While eventually these clearances were theoretically received, they were addressed to the wrong institution or covered the wrong set of companies, so a proper clearance was never received. The full team was never received by Deputy Minister Freyberg, the official sponsor of the project.

As a result of these difficulties, the financial analyst Tom Flohr left and was replaced by Jerzy Gabrielczyk, who worked for several years in the Polish steel industry as the British Know-How Fund consultant. The study of the chemical industry was abandoned. The analysis of the steel industry proceeded on the basis of public materials and the professional knowledge of the consultants. Virtually, in the last days of the study, the team was able to meet with sector experts from the Ministry of Industry and to obtain an appointment with the management of Huta Katowice. While the report contains no official information, the team believes that its analysis and recommendations are valid, based on considerable experience with privatization and the steel sector in Poland.

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I. INTRODUCTION:

Poland's announced primary goal is the accession to Western political and economic institutions, mainly the European Union. The 1993 Copenhagen meeting of the European Council stated that its condition for the acceptance of Poland and other possible states is the adaptation of economic policies and the regulatory institutions to the EU environment. In broader terms, it means a transition from a planned to a functioning market economy and the ability to cope with competitive pressures and market forces within the Union.

In view of the EU's requirements, Poland must address the hitherto neglected issue of the restructuring and privatization of large state-owned enterprises which often are struggling for economic survival. This applies in particular to heavy industry sectors whose functioning is often regarded as strategic by the state and whose survival is connected with employment for tens if not hundreds, of thousands of people, and is therefore highly politicized. It is the successful restructuring and privatization of these politicized heavy industry sectors that will mainly determine the suitability of Poland to accession to the European Union.

One of the chief industries that must adjust to the European Union market and cope with its competitive pressures is the steel industry. This industry experienced a deep crisis in 1991-92 that threatened its survival. Since then, it was largely neglected and restructured on the initiative of its own managements and many enterprises went out of business. To cope with competitive pressures of the European Union and to serve its own changed domestic market, the steel industry must continue restructuring and technological modernization that requires enormous financial resources. The Polish state does not possess such resources, even though it tried to support this effort through government guarantees of bank loans. These have now come to an end. In addition, one of the EU's requirements in regard to the steel sector is the avoidance of state aid.

In view of the demands of the European Union market, the Polish steel industry must continue its restructuring and modernization and the resources for it can only come from private investors. However, the industry must be restructured in such a way as to make it possible and attractive for private investors to get involved. The goal of this study is to analyze the competitive pressures within the enlarged European Union, examine their implications for the restructuring of the Polish steel industry, and to map out a strategy of its privatization.

II. OVERVIEW OF THE POLISH STEEL SECTOR:

II.1 The Polish iron and steel industry is one of the main branches of Polish economy with long traditions, augmented by the postwar reconstruction effort and an emphasis on heavy industry of the communist ideology. Large capacity was built up in the 1940's and 50's, and then extensively modernized in the 1970's. As a result, steel production reached a highpoint of 19.5 mln tons in 1980.

II.2 1980 marked the beginning of the political and economic crisis in Poland which deeply affected the steel industry. The rapid deterioration of the economy led to diminishing steel demand, and the lack of resources and foreign credits did not allow further modernization of the sector at a time of the technological revolution in the steel industries of highly developed countries. As a result, Polish steel industry became backward and undercapitalized. This was evidenced by the fact that as much as 30 percent of steel was produced in open-hearth furnaces and as little as 7.7 percent of steel output was continuously cast.

II.3 1989 marked the beginning of the political changes and the transition from planned to a market economy. This system transformation deepened the crisis of the Polish steel industry. The financial austerity imposed by Balcerowicz led to a state of financial emergency and a concentration on a struggle for survival at the expense of long-term goals. Particularly damaging was the collapse of the Comecon trading system, especially the large Soviet market, where Poland exported large quantities of heavy steel consuming equipment (complete industrial plants, railway stock and ships, construction machinery). The Polish market was also in a deep recession and the housing industry collapsed. In 1992, the Polish steel production reached its lowest level of less than 9.8mln tons. Over the period 1986-1992 per capita steel consumption in Poland fell from 321 to 113 kg/capita.

II.4 The Polish government considers the steel industry as one of the strategic sectors, and decided to start the process of restructuring in order to make it competitive in world markets. It commissioned a study of the possible restructuring strategy in March 1991 from the Canadian Consortium of consulting firms. The study was completed in June 1992 and later endorsed by the government as the authoritative strategy of restructuring. This was the first sectoral restructuring plan. The clear goal of the government is to make the steel industry competitive, especially in the domestic market. The Canadian Consortium study recommended a drastic reduction in the Polish steel production capacity, the grouping of the steel enterprises under one integrated management, and the inevitable closure of weaker and smaller steelworks.

II.5 The Canadian plan was never implemented as it was stalemated by the resistance of the individual steelworks over which Ministry was never able to exercise proper ownership control. By the end of March 1996, following a major industry conference arranged by the Ministry of Industry, the Ministry announced that it was no longer

supporting the Canadian plan, and that each steelworks could prepare its own, stand-alone plans for restructuring and privatization. The government would support these plans by giving state guarantees of 60 percent of the loans made by Polish banks.

II.6 In fact, the fall in consumption of steel bottomed out in 1992, and 1993 showed a small recovery. Since then, demand has grown significantly, at a rate estimated by the Industrial Development Agency to exceed 5% per annum. Significantly, during the same period, import growth has been very substantial in certain segments, in particular in coated flat products (particularly zinc - a growth of 8400%). This reflects the change in the market structure in Poland (see also below), and sets the trend for the future. Overall, with the progressing recovery of Polish industry, demand and production has risen to 12 and 9 million tonnes respectively in 1995.

II.7 The financial performance of the Polish steel sector in recent years has been as follows (000,000 Pln):

	1992	**1993**	**1994**	**1995**
Sales	4.638	5.867	8.465	12.776
Operating income	(16)	126	383	740
Income pre-tax	(232)	(60)	1	778
Income post-tax	(454)	(272)	(93)	340

II.8 However, within the overall figures, the mix and patterns of demand have altered, in an invisible change as fundamental as the straightforward volume loss previously experienced. Volume production of long products with little added value has declined as a proportion of total production, with much more demand forthcoming in flats, particularly wide gauge coated sheet steel.

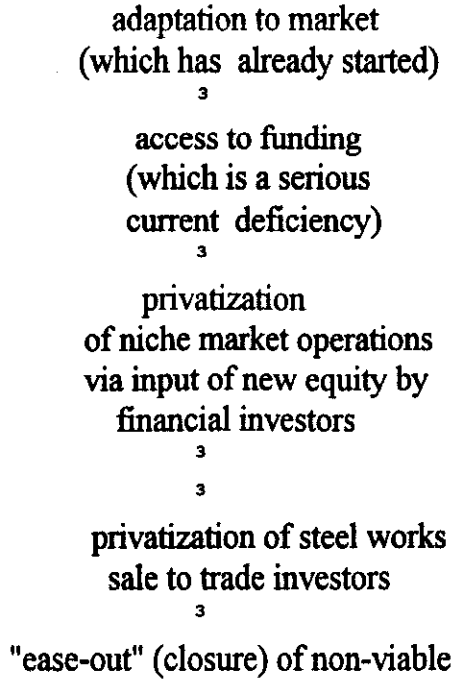
II.9 Right now, the Polish steel sector is highly fragmented, greatly overmanned, with substantial overcapacity and yet with enormous investment needs and no ability to access funding. Its productive machinery is old and inefficient and it is a major source of industrial pollution. Its immediate competitors, Western European corporations, are larger, much more modern, slimmed-down, efficient and hungry for new markets. The Polish steel user marketplace is attractive and likely to become even more so. So what should be done to allow Poles to be competitive in their own marketplace?

II.10 It might be appropriate, before attempting to answer this question, to ask another - should Poland have a steel industry? The Polish steel industry is nearly entirely Government-owned, and by starving the steel industry of investment, and by general inaction, it would be a simple matter to allow foreign steel to progressively come to dominate the domestic market. In this report, the assumption has been made that the strategic significance of the steel industry makes it a necessary part of Poland's industrial infrastructure.

II.11 The Polish steel industry would not have any chance of surviving if it had to compete immediately and directly with its Western competitors today. To survive, before it is exposed to the full rigour of market forces, it needs a period of acclimatization and adjustment. This period of protection will allow for the improvement of quality, for the introduction of efficiency, for the creation of proper, customer-orientated distribution networks. In turn, this will provide a valid basis for long-term survival on a proper economic footing.

II.12 The question is then, how can the Polish steel industry best be acclimatised to market economy conditions, and over what period, and how this restructuring period can best be blended with the necessary access to capital (and therefore, ownership changes). The priority sequence of adaptation to market, access to capital and lastly, privatization, is deliberate. Any other sequence will create the risk of wasted capital, or of closure of the SOE concerned.

II.13 This report envisages that the SOEs which make up the Polish steel industry will undergo the follwing process:



II.14 Polish steel production peaked in 1980, when 24 steelworks produced 19.5 million tonnes of raw steel and 13.5 million tonnes of rolled products. Currently, production runs at just under 12 million tonnes of raw steel and 9 million tonnes of rolled products. Two steelworks account for about half of the Polish production of raw steel. Huta Katowice is Poland's largest producer and makes long products, with Huta im T Sendzimira (the former Huta Lenina) a producer of flats, in second place. In all, some 11 steelworks still produce raw steel and function more-or-less on an integrated basis, while many steelworks have ceased raw steel production and restructured themselves into niche product manufacturers.

III. ATTEMPTS TO RESTRUCTURE THE POLISH STEEL INDUSTRY:

III.1 The privatization approach-

III.1.1 The instrument of adjustment of state enterprises to a market economy is privatization. In Poland, however, the chief aim of privatization is the maximalization of revenues for the government budget. Thus, the legal framework for privatization was inappropriate for large, inefficient state enterprises which could not bring a high sale price. The practical application of the 1990 law on privatization of state enterprises differentiated privatization strategy based on the size of the enterprise. Medium enterprises could be sold whole or contributed to a joint venture, or they could be leased to employees with an option to buy. Such management/employee buyouts turned out to be the most popular privatization option.

Large state enterprises were restructured by spinning off the social sector and "commercialized" by legal transformation into state joint stock companies. These companies could then be privatized either by the initial public offering on the stock exchange or the sale to the strategic investor. Generally, this procedure applied to reasonably good companies. Enterprises in bad financial shape could only be sold to a strategic investor under special conditions, such as granting of monopoly rights on the Polish market. Altogether, about half of the 8,000 state-owned enterprises, existing in 1990, have been privatized, but this figure includes only a few large state-owned enterprises. The large SOEs which have been sold have been attractive from a market position point of view, and only in one or two cases has there been any need for extensive restructuring in parallel with privatization (FSO is a notable example).

III.1.2 Undoubted successes have included the privatizations of a significant number of Foreign Trade Organisations ("FTOs" - Przedsi_biorstwa Handlu Zagranicznego), such as Agros, Stalexport, Elektrim and others, and of a number of the banks. However, Ciech, the chemical and petrochemical FTO remains unprivatised, as do many of the major banks (Bank Handlowy, Bank Gospodarki _ywno_ciowej, the two PeKaOs).

III.1.3 In troubled heavy industrial sectors the pace of privatization has been very much slower, or entirely absent. The coal extraction sector and most other extractive industries, steelworks, shipyards and other heavy industry, where substantial downsizing and restructuring is required to match market conditions, are largely untouched. In a number of instances, the large SOEs involved defy the government with impunity and ignore multi-million dollar liabilities for unpaid social insurance contributions and taxation (eg Ursus).

III.1.4 Thus, the privatization framework does not address the issue of large inefficient state-owned enterprises and the government has perceived large problem enterprises as a danger to avoid, and little or nothing has been done by the State to achieve their privatization (or to support their restructuring). Ursus (the Warsaw-based tractor manufacturer), Huta im T Sendzimira steelworks, Starachowice (the medium truck manufacturer) and many others received no direction or help until political and social pressures at the enterprises forced central Government to react. The government had no funds with which to support restructuring, or even to provide a sensible social safety-net.

III.1.5 As far as the objective of restructuring Polish heavy industry is concerned, the Polish privatization process has not had much impact. Funds gained from the sale of successful SOEs have been absorbed by the Budget instead of being rechannelled for restructuring, zero-proceeds sales of derelict enterprises have been made impossible through excessive politicization of the privatization process, and attempts to create mechanisms which would permit parallel restructuring-with-privatization have been blocked. The troubled enterprises themselves, in need of extensive restructuring (overmanning, modernization, pollution), have not been attractive for investors, and the absence of social safety-net funding has promoted employee anxiety and resistance to any form of change.

III.1.6 However, over the six years since the market reforms, Polish central government has forced the sensitive sectors of Polish industry to commence restructuring by the implicitly adopted policy of setting progressively-reducing boundary conditions (tariff/quota barriers) and providing as much direct support as can be won by each individual enterprise. Individual privatization has been avoided except where opportunities have presented themselves (Lucchini). This policy has forced the gradual acclimatisation of sector enterprises to market conditions over the period during which the barriers are being reduced and it has forced significant structural changes to take place in Polish sensitive sectors, including steel. The attached steel sector case studies present examples of those changes.

III.2 The approach to privatization of the steel industry

III.2.1 Practically all steel sector SOEs are sufficiently large to fall into the capital privatization route, where any privatization would be conducted by the Ministry of Ownership Changes and now by of the Ministry of the Treasury.

III.2.2 A major problem encountered under the capital privatization route is the lack of synchronisation or agreement of policy and strategy between the owner (the State Treasury) and the management of the SOE (and often, the unions). The owners' actions, in securing the highest bid, are often seen as contrary to the interests of the enterprise undergoing privatization, particularly when (as is often the case) the tenderer is a Western competitor. Because of the globalisation of the steel industry, this problem is unavoidable and will be particularly accute in the case of the privatization of Polish steelworks by this method. This problem is further exacerbated by the need for high investment if production is to be maintained.

III.2.3 Both of the two now-private sector steelworks were both originally State-owned. Significantly, neither were privatised via the privatization law. The mechanisms in each case were as follows:

Luccini - under the joint venture law, a joint company owned by Italian steelmakers and the former SOE;

Stalprodukt - under Article 46A of the law on SOEs, a joint company owned 40% by HTS and 60% by its employees (Article 46A permits the hive-down into wholly-owned subsidiaries of SOE fixed assets. SOEs can then freely dispose of the equity of those subsidiaries. This is not in any way related to the law on privatization).

III.2.4 It is unlikely that the steel sector can be simply privatised by a program of straightforward capital privatization sales (as eg., the brewery or cable sectors). The fragmentation of the industry, the need for capital, and, most important of all, the resistance of employees and management, are likely to be insurmountable obstacles. Probably for this reason, the Polish Government has not attempted to implement this route and the majority of steelworks remain unreformed state-owned enterprises and will be transformed into state joint stock companies by the end of 1996, some are management-employee buyouts, some belong to the National Investment Fund program, and Huta Czestochowa has been assigned to the shipbuilding holding company.

III.2.5 Instead of an auction of the industry, there needs to be developed and implemented a documented policy of progressive restructuring (ie., adaptation to market conditions),

which will strengthen and consolidate the industry in an evolutionary way, leading naturally to a change in ownership.

III.2.6 In fact, the managements of most of the steelworks have been implementing just such a policy (admittedly in the main, in the absence of any support whatsoever from the government) over the last 4-5 years. In some cases, the positive effects are clearly visible.

III.2.7 The current management control of most of Polish steel works is weak but improving. The problem is rooted in the previous command economy, where enterprises were typically monopoly producers of their products. Fewer and fewer Polish steelworks have internal structures orientated towards the old environment, though all have a burden of the legacy of the past. The internal changes are being initiated by individuals who have seen the need for a new orientation and are working in a very difficult environment, trying to match the new and demanding marketplace to the inflexible old SOE structures, without any help from government agencies.

IV. PROSPECTS FOR THE POLISH ECONOMY:

IV.1 The outlook for the economy-

IV.1.1 The Polish economy continues to grow apace. This year, reduction of inflation and interest rates have acted as stimulii to promote industrial investment. Improved enterprise profitability and growth in real personal earnings have stimulated consumption. The goal of the government is to maintain the consumption growth and to reduce the level of unemployment. Its official economic strategy 'Poland 2000" makes the following projections of macroeconomic indicators for 1996-2000:

	1995	1996	1997	1998	1999	2000
Gross Domestic Product	7.0%	6.0%	5.5%	5.3%	5.1%	5.1%
Consumption	4.4%	4.5-4.7%	3.2-3.6%	3.2-3.6%	3.1-3.6%	3.1-3.6%
Gross investments	19%	10.5-13%	9.5-14%	9.5-12.5%	10-10.5%	10-10.5%
Imports	21.1%	11.5-13.6%	8-13%	7-10.3%	6.5-8.6%	6.5-8.3%
Exports	17%	13.4%	12.4%	10.0%	8.4%	8.3%
Unemployment rate	14.9%	13.6%	13.1-13.4%	12-12.4%	10.7-11.3%	9.4-10.2%
Inflation	21.6%	17%	12%	8-10%	6-8%	5-7%

IV.1.2 In its latest quarterly report (report for the period ended 30 September 1996), the independent Polish Institute for Market Economy Research (*Instytut Bada_ nad Gospodark_ Rynkow_*) published its latest "key indicator" forecasts as follows-

Change in	1995	1996	1997	1998
Gross National Product	7.0%	4.7%	5.3%	5.4%
Growth in real earnings	3.2%	5.5%	4.6%	4.0%
Disposable income	11.7%	11.3%	10.2%	10.5%
Imports	22.7%	20.8%	10.8%	8.4%
Exports	18.4%	6.6%	8.0%	8.7%
Industrial investment	18.5%	18.5%	16.0%	14.7%
Inflation	27.8%	20.0%	16.6%	13.0%

IV.1.3 The published statistics, as well as anecdotal data, indicate that the Polish consumer class is increasingly affluent and is driving the economy in the direction of imports; at the same time, local businesses are seeking to compete with importers through investment in modernisation and development.

IV.1.4 On a macro level, the direction of development of the economy suggests that the Polish Government will have little option but to continue anti-import measures (tarrif barriers), so as to provide a measure of protection to enable Polish industry to re-equip and eventually to compete on an equal footing with Western competitors. The required length of this process of "coming to market" will dictate the date at which Poland might be ready to joint the European Economic Community.

V. INTEGRATION WITH THE WORLD & EU ECONOMY:

V.1 World steel market outlook-

It has not been since the 1950's that world steel market commentators have been so bullish on the outlook for the global steel industry. This arises from generally low world inflation levels and sustained high growth rates, principally in Asia. However, the focus of demand is continuing to shift to the emerging market economies.

The growth rates in the developing world will create even higher growth rates in steel consumption in these markets as per capita metals' usage increases towards levels in the developed economies. World Bank estimates of the mix of world output between the developing world and the industrialized countries changes from about a 50/50 mix currently to a nearly 65/35 mix in favor of the developing world across the next 25 years. This implies sustained higher demand and growth rates for steel products.

The Paine Webber World Steel Dynamics Report of May 1995 predicts that steel companies will reap benefits of their recent modernization. Particularly, given similar levels of efficiency, integrated flat-rolled producers (with blast furnaces) are expected to generate higher operating profits over the cycle than EAF-based producers. The integrated steelmakers that are low cost, will enter a "golden decade." Global steel demand will grow steadily and profits will improve.

The current technological revolution within the steel sector will continue to create winning opportunities for the aggressive. But this can only be successful if production costs are pared and product quality upgraded at a rapid rate. Raw materials suppliers to the industry have particularly good prospects. A significant shortfall of steelmakers' metallics, i.e. high prices for steel scrap, steel scrap substitute materials, and metallurgical coke, will develop by the year 2000, and there will be new investment in this area. With relatively high demand and high utilization of capacity, prices are expected to be volatile, with periods of very high (and low) prices expected in spot export markets.

V.2 European Union steel market outlook-

Poland's accession to the European Union has now officially become the most important goal for the Polish government and a yardstick for an adjustment of its industry to the Union standards. Thus, the competitiveness of the Polish steel industry and the outlook for steel capacity and production within the European Union are relevant in the consideration of any modernizing, downsizing and/or expansion of the Polish steel industry.

According to the Salomon Brothers World Steel Investment Report of October 1996, Europe has a very competitive steel industry. Despite current favorable conditions in the global steel industry, the European Union is considered to have an over-capacity of steel

production in the neighborhood of 30 million tons per year. 25 percent of EU steel production is exported outside of the region. 20 percent of European exports go to the US but the US market is considered less promising as in the next few years as considerable amount of new capacity is coming onstream there. However, due to shutdowns of unproductive old capacity, it might not have such a big impact there. There are also grades of steel which the US has to import because they are not made domestically, such as very high carbon wire rod for tire applications.

Europe is also exporting considerable amounts of steel to the Far East. Until 18 months ago, China was importing large amounts of steel because its domestic producers were unable to keep up with demand. In 1993, it imported 36.5 mln tons -more than the output of France and the UK combined. In August-September 1996, there were again signs of a pickup. However, the European steelmakers might not be the ones to benefit. There is a considerable quantity of CIS material warehoused in China, some currently offered for resale outside - even in Taiwan. Other beneficiaries may include the Japanese who have sustained relationships in China and transport cost advantages. It is expected that by the year 2000, up to 30 mln tons new steel capacity will be made available in the Far East but there still will be room for European imports.

According to Terence Sinclair of the Salomon Brothers Steel: European Equity Research, many East European mills have made considerable strides in restructuring in the last five yeaers but, with some exceptions, there is no significant change in their impact on Western European customers and their traditional Western suppliers. East European producers have already made their impact, increasing their exports to the West for the past eight years. He expects East European steel to take a much bigger role after the next business cycle.

In terms of the structure of the European industry, a handful of producers dominate European steel and consolidation is increasing their power. Western Europe produced 170.4 mln tons of steel in 1995, 90 percent of it in the EU. Production is concentrated by country. Germany and Italy are the largest producers of steel in Europe., each with several mills focused on all the main product areas. Germany produces almost 25 percent of European steel, Italy 16.5 percent, France and the UK about 10 percent each. Demand is equally focused but is slowly diluting with the re-emergence of Eastern Europe.

Six of the world's 25 largest steel producers are in Western Europe. Three are in the world top five: British Steel, Usinor Sacilor and the privately owned Riva. Together with Arbed, Thyssen and Krupp Hoesch, these six producers account for approximately 40 percent of Western European steel. European producers are consolidating their operations but at a very slow rate. Despite downsizings, asset swaps and mergers, overcapacity persists, and therefore profitability will not improve. Capacity cuts planned by the European Commission are difficut to enforce because the politicization of the industry. However, governments own only 18 percent of Western Europe's major steel producers.

There are also significant roles taken by unlisted private companies, especially the Riva Group, Ispat, and Lucchini. Expectations are that smaller steelmakers will disappear, especially in Belgium and Germany, and be acquired by the larger ones.

Despite this overcapacity, there is investment in the next generation of coating and steelmaking technology in three areas: installation and renewal of coating capacity, especially for automotive dedicated hot dip lines; thin slab and strip casters; and flat-roll capacity where a new 1.5 mln tons hot rolling mill at Cockerill Sambre's EKO Stahl plant on the Polish-German border will work to 60 percent capacity after startup in 1997 by agreement with the EU.

Capacity creep is of course harmful to earnings. But the European steel industry still has approximately 20 mln tons of spare capacity in the trough of the cycle but is short of capacity at the peak. However, individual steelmakers are not necessarily injured by the industry's capacity increases. For example, Usinor Sacilor has a combination of low marginal cost and high long-term contract proportion which protects it against the marginal pricing behavior of some of the flat rolled producers. However, the most urgent effect of new capacity increases is to shift the competitive base as players on the cost curve, those with the lowest costs recover quickest from troughs.

In a speech at the 1994 Steel Survival Strategies conference in New York, Horst Weitzmann, Chairman of BSW/NDW Group of Kehl,Germany, said that as a result of early 1990's imports of steel from Eastern Europe, price of commodity steel products dropped by 30 to 40 percent.

The successful trend in Europe is electric steelmaking in integrated mills. To become more efficient, integrated mills have to split up their corporations into smaller organizational units and independent smaller units, to enable them to merge in some smaller product areas with competitors. Usinor-Sacitor has already followed such a strategy, and Krupp and Thyssen are following suit.

V.3 CEFTA/CIS/NIS steel market outlook-

The outlook for capacity, production and demand within the CEFTA/CIS/NIS markets is perhaps the most difficult to ascertain as the condition of the capacity, relative costs and rate and nature of the recovery of demand in these markets remains extremely difficult to predict. According to a 1996 study on "Global Study on Steel in Europe," in the Czech Republic, since 1992 production capacities have remained essentially unchanged and thus long product rolling mills are dominating in production. The production volume of hot flat products did not change significantly, while that of cold rolled coil decreased to less than half of the earlier quantity.

In Slovakia, the steel industry and its capacity remained the same. The production capacities of flat products are quite big for the size of the country, and there is a lack of long product manufacturing capacities, as a result of separation from the Czech Republic. In Hungary, the capacity of heavy section mills were nearly halved, otherwise no important changes took place in the last three years. Production increased dynamically by 25 percent between 1992 and 1994. Production capacity of Romanian mills also decreased by nearly half in some instances.

Despite the positive outlook for the global steel industry, a major "wild card" remains the capacity/output of the Russian and Ukrainian mills, which have been operating at low levels reflecting low levels of demand in their market, but which are increasingly seeking to access export markets which will accept their products. Currently, output is increasing at rates of 10% to 20%, largely for headed for export markets. In 1995, Russia was the second largest net exporter of iron and steel products (20 million tons) after Japan.

According to the study, in Russia, raw steel production fell from 67 mln tons in 1992 to 49 mln tons in 1994. Production offinished products fell to less than 2/3 of the volume produced in 1992. Imports decreased 10-fold., while exports almost doubled. In the Ukraine, raw steel production decreased from 42 mln tons to 24 mln tons. Production of finished products diminished in a similar proportion. Exports declined slightly.

It appears safe to say that prior capacity and production in the region will not be achieved on an economic basis without considerable investment and increase in demand within the region. As the availability of and absorption capacity for investment and the recovery of demand varies and will continue to vary dramatically in the region, the issues and opportunities arising with regard to steel production will remain difficult to predict.

VI. CURRENT SECTOR CONDITIONS:

VI.1 Profit performance-

VI.1.1 The financial performance of the Polish steel sector in recent years has been as follows (000,000 Pln):

	1992	1993	1994	1995
Sales	4,638	5,867	8,465	12,776

Operating income	(16)	126	383	740
Income pre-tax	(232)	(60)	1	778
Income post-tax	(454)	(272)	(93)	340

VI.1.2 The statistics amply demonstrate the recovery that the Polish steel sector has made from the disastrous effects of the recession in 1990/91. However, it should be noted that the after-tax losses in the early years were further increased by the imposition by central government of excess wages tax ("*popiwek*") and that the financial resources of steelworks were further depleted by "dividends" payable to central government irrespective of the presence or absence of profits ("*dywidenda*").

VI.1.3 The recovery can be qualitatively attributed to the following factors:

i) growth in demand, world-wide, for steel;

ii) the recovery of the Polish economy;

iii) the combined effect of the operational restructuring programs performed by individual enterprises - this includes the spin-offs of social assets and ancilliary operations, technical improvements, in particular the installation of continuous casters and the closure of open-hearth plant, and the shut-down of old and uneconomic production;

iv) the effect of financial restructuring - in particular, debt forgiveness programs.

VI.1.4 It should be noted that hardly any of the steelworks have been privatised, and that the restructuring has been performed by the incumbent managments working within a State-owned enterprise format.

VI.1.5 Very few of the enterprises were confident that their data showing segmental product profitability was reliable. Little information was available on marginal costs of production/sale, or indeed on cost structures.

VI.2 Balance sheet conditions-

VI.2.1 The financial condition of individual enterprises varies from enterprise to enterprise. We were unable to obtain full data, but anecdotal data indicated that no

enterprise was in a position to fund its own internally-determined investment program out of cashflow plus commercial banking sources. A significant number of enterprises had availed themselves of the opportunity under Polish law to initiate a program of debt reduction, either led by the bank (*"bankowe post_powanie uk_adowe"*) or by the court (*"s_dowe post_powanie uk_adowe"*). In a number of cases, enterprises were suffering poor cashflow, because customers were taking goods and paying for them with the enterprise's own unpaid liabilities (*"kompensata"*), which they had acquired from suppliers to the enterprise (such as coal mines).

VI.2.2 It was clear that the major Polish steel producers, HTS and HK, were unable to borrow any significant sums based solely on the strength of their own balance sheet. Their recent capital investments had been financed by the banks (in what appeared to be a brave venture) substantially on the basis of central government guarantees. The absence of further government guarantees was stopping further lending and hence further investment spending. Indeed, it was difficult to see how in the absence of government guarantees, these entities might provide real, realisable security cover for principal and demonstrable quality, cash income cover for interest and repayment tranches.

VI.2.3 It was equally clear that the niche producers surveyed (Stalprodukt, Florian) had much better balance sheets, and indeed, had unused borrowing capacity (which was, however, insufficent to fund their investment needs). However, they were much better able to point their development strategy in specific and attractive directions, and thereby create an appropriate environment for attracting venture/risk capital. However, in the case of State-owned enterprises, the legal rules made gaining venture capital difficult if not impossible.

VI.3 Capacity and investment planning-

VI.3.1 The early 1990s were characterised by attempts at balancing industry capacity with the then level of demand. Against this background, there was a long-drawn-out struggle between Huta im T Sendzimira ("HTS") and Huta Katowice ("HK")for supremacy in the Polish steel producing marketplace (even though the two were not really competitors). There was no clear winner in this struggle, solutions suggested by central government were unacceptable at enterprise level and could not be centrally imposed, and each enterprise pursued its own chosen development path.

VI.3.2 In the event, the improved economic conditions of 1994 onwards reduced the intensity of these arguments, and to some extent superseded them. The emphasis is now on gaining funds for investment, rather than avoiding closure and redundancies. While the question of industry-wide capacity is still discussed, the issue of implementation of any agreed approach has seemingly been skirted, and central government has provided financial support (in the form of guarantees) for both HTS and HK, as well as for other steelworks.

VI.3.3 The current situation is that most steelworks are profitable and are contemplating investment, most of which is destined for modernisation and restructuring purposes. While levels of demand and competition are important, the limiting factors at steelworks are:

- o the availability of funding for investment;
- o the security/stability of market prices to enable the sourcing of funds;
- o social issues relating to the acceptance of change by the workforce.

This situation is made worse by the fact that there are no direct legal mechanisms for State-owned enterprises to access risk/venture capital funds (however, there are indirect mechanisms). Additionally, for those State-owned enterprises which are *przedsi_biorstwa pa_stwowe* ("PPs"), the paramount role of the Workers' Council as the main organ of internal governance serves to strangle change and presents an additional hurdle for management.

VI.3.4 Repeated attempts at integrated, pan-Polish industry capacity planning, have proved unworkable in practice.

VI.3.5 There is a substantial need for capital investment in the Polish steel sector. The estimated costs of restructuring the Polish steel industry, as assessed by Ministry of Industry sources, are:

	US$ millions
New plant	1,650
Modernisation of plant	1,200
Pollution control	750
Social safety-net	300
Debt forgiveness	550
Total	4,450

VI.3.6 Technological change statistics make for interesting reading. Whereas in in 1980, Poland produced 19.5 million tonnes of steel, of which roughly half was produced in open hearth furnaces, by 1994, only 1.6 million tonnes was produced in this way. By the year 2000, all open hearth production will have ceased. Similar, continuous casting, which in 1994 was used in the production of 12% of output, grew to 30% in 1995 and will account for approximately 60% in the current year. These changes' implications are a dramatic improvement in the cost structures of the industry, as well as a marked reduction in pollution levels.

VI.4 Sources of financing-

VI.4.1 Polish capital markets are still relatively young and shallow. However, they have undergone dramatic growth and development over the last six years. The combination of indigenous Polish capital sources (including the Warsaw Stock Exchange) and foreign financial institutions present in Poland (some of which are very substantial - eg., most of the German banks, venture funds managed by Enterprise Investors, International Finance Corporation) can provide substantial funding on a private sector basis for suitable investment projects.

VI.4.2 It has to be emphasised that the majority of Polish steel sector companies would fit the investor definition of "recovery situations" with poor security covenants. For this reason, the generic nature of the funding will be predominantly classified by investors as risk (ie. equity) investment.

VI.4.3 The Polish steel industry is still largely state-owned, and entities are either PPs or joint stock companies with all of the issued shares owned by the State (*"jednoosobowe spó_ki skarbu pa_stwa"*). This structure restricts the access of enterprises to funding, as it eliminates the possibility of the direct accessing of risk (ie. equity) capital under the control of the enterprise's management.

VI.4.4 Estimates of the cost of restructuring the sector range between the US$4,45 billion set out in VI.3.5, up to US$6 billion. There is no identifiable source for these funds.

VI.4.5 Investment funding hitherto has been from cashflow of individual steelworks, and from bank loans (or extended supplier credit) secured by government guarantee.

VI.4.6 Funding in general is available to Polish enterprises in the form of borrowings (and quasi-borrowings) and equity finance, as follows:

i) Bank loans - because of the sums involved and the relatively small size of the Polish banks, funding would need to be done via syndicated loans. However, there are a number of problems with bank lending. Firstly, syndicated loans are a new product in the Polish marketplace; secondly, the nature of the security on offer is often poor (questionable or undocumented title to land and buildings, unsaleable contaminated land and restricted alternative-use buildings); thirdly, prior ranking charges often exist (unsettled Polish State treasury debts, ie. taxes, and ZUS take precedence even over prior mortgage charges); fourthly, often, the ability of the enterprise to service the loans cannot be demonstrated based on achieved performance; and finally, the projects are long-term in nature, with lengthy paybacks, while the sector has hitherto not been seen as attractive or robust. For these reasons, banks have asked for, and received, government guarantees for all substantial investment loans actually made in this sector.

ii) Money market - a recent development has been the ability for all classes of enterprises to discount unsecured bills in the Warsaw money-markets. A number of the better steelworks are involved in exploring the use of this facility to raise funds, but it should be noted that such facilities are short-term in nature (three to six months) and are therefore fundamentally unsuitable for funding fixed asset investment.

iii) Quasi-borrowings - structured finance, particularly leasing of plant, has been used by many enterprises to match investment spend with cashflow earnings. However, its use in the steel sector is severely restricted due to the specialist nature of the plant. Additionally, the amounts involved exceed the capacity of the Polish lease finance marketplace at present.

iv) Direct equity injection - this is only available to entites which have liability limited by shares (*"spó_ka akcyjna"*) or by funds contributed (*"spó_ka z ograniczon_ odpowiedzialno_ci_"*). Thus no PPs are able to source direct equity funding while remaining in that legal form. The route to capital injection generally envisaged for State-owned enterprises is via privatization, either by **capital privatization** (*"prywatyzacja kapita_owa"*), that is commercialisation (conversion to a joint stock company) and subsequent privatization sale, followed by an injection of investment funds; or by **liquidation privatization**, whereby the business and net assets of a PP are contributed to a new joint stock company funded by the incoming investor (*"prywatyzacja likwidacyjna"*). In both cases, funding input is from the incoming investor. No capital privatization has yet taken place in the steel sector. Huta Luccini was privatised by the contribution of the business and part of the assets to a joint venture legal entity. Stalprodukt was "privatised" under the spin-off provisions of the PP law.

v) Indirect equity injection - this form of funding is common in many sectors in the form of joint-ventures, whereby the State-owned enterprise contributes assets or parts of a business, and a trade investor contributes cash and technical or other skills. The Huta Baildon/Sandvik joint venture is an example. However, despite the well-established routine of these transactions, relatively few such spin-offs have been performed with purely financial investors.

vi) Spin-off followed by equity refinancing - this is the Stalprodukt privatization and funding route, whereby the grain orientated silicon steels business of HTS was spun-off into a company 60% owned by its employees and 40% owned by HTS. This business has been substantially streamlined by its management, and is currently seeking finance for expansion by means of a planned share issue on the Warsaw Stock Exchange.

VI.5 Financial restructuring-

Many enterprises in this sector became substantially indebted as a consequence of the losses suffered during the deep recession in 1990/91. Polish legislation enables indebted enterprises which are capable of surviving, to undergo financial restructuring.

VI.5.1 Tax offices are empowered without limitation to write-off and/or reschedule arrears of tax and interest on unpaid taxation in instances which are "economically and socially" justified. These write-offs apply equally to private and public sector enterprises.

VI.5.2 ZUS (Polish social security insurance) offices are empowered to reschedule payments of arrears of ZUS. They may not write off overdue amounts. However, it appears that in some cases, central government might grant enterprises funds with which to repay arrears of ZUS.

VI.5.3 *Post_powanie uk_adowe* (debt rescheduling) is a procedure applicable to all enterprises which are in temporary financial difficulty. This procedure, which is initiated by the enterprise, embraces all unsecured creditors on a compulsory basis, as well as secured creditors, on a voluntary basis. The procedure, which is supervised by the court, involves assessing the future viability of the enterprise and reducing and rescheduling the creditors to match expected cashflows. Creditors can be reduced by 60% or more, and payment can be spread over any period. However, the terms of the rescheduling must be approved by an appropriate majority of the creditors by number and value. A number of steelworks have passed through the *post_powanie uk_adowe* process, including HTS.

VI.5.4 *Bankowe post_powanie ukladowe* is a bank-led version of *post_powanie uk_adowe*, which can additionally involve debt/equity swaps. However, there are ownership criteria which favour State-owned enterprises.

VII POLISH STEEL MARKET OUTLOOK & PROSPECTS:

The outlook for the Polish Steel Sector is considerably better today than it was at the time of the preparation of the Canadian Study of the Polish Steel Sector prepared at the bottom of the Polish steel market in 1992. A number of the Hutas identified for closure in that study have become profitable and even attracted foreign investment, and, indeed, it is believed that all of the Hutas in the Sector are now profitable on an operating basis. The Polish Steel Sector remains the largest producer in Central Europe, excluding the NIS/CIS. Domestic production in 1995 was 6.3 tons, a compound growth rate of 23% from 1992-1995. 1995 exports were 3.5 million tons. Total raw production was estimated at 11.8 million tons in 1995.

It would appear that the demand projections of the Canadian Study were conservative, and that the growth in the Polish economy is currently sustaining a growth in steel demand

within Poland in the range of 8% to 10%. This growth, viewed in light of the lower per capita steel intensity of the current Polish economy relative to other developed economies, the favorable outlook for domestic production, both for domestic consumption and export, of automobiles and white goods, and the increasing use of steel in construction activity in Europe generally, all point to continued growth in domestic steel demand that will require capacity and production in excess of the targets of the Canadian Study. Indeed, if high value flat products demand is to be met by domestic production and not by any imports, the required flat product production increases needed are estimated to be over 1.25 million tons by 2010.

The Canadian Study recommended that Polish steel capacity and production focus principally on domestic demand. It seems clear, however, that the historical capacity, technology and skills of the Polish industry should allow for some portion of its capacity to be reasonably targeted to export markets. Indeed, with export prices for steel products at high relative levels, this is an opportunity for the Polish industry to earn some of the considerable revenue needed for its modernization and product production shifts. Opportunities for exports to Poland's recent traditional markets in the CIS/NIS should recover as these markets appear to have bottomed out and their own domestic production capacities will likely lag in their recovery capabilities both as to production amounts and product quality. Other markets, including EU markets, should be interested in imports of Polish steel products where the cost of the Polish products is more competitive reflecting Poland's lower labor costs. Indeed, EU interest in Polish scrap is subject to specific quotas, with scrap shortages an issue for modern mini-mill production activity. It seems clear that a review of Polish steel demand should be made to reflect current economic conditions and outlook, and that potential export markets be considered in capacity planning.

VII.1 Long versus flat products dilemma-

VII.1.1 Traditional patterns of consumption and the combination of heavy exploitation in the '80s, recession in the early '90s and the change in demand has left the Polish steel industry short on production capacity in the key growth sectors, and with excess capacity based on unmodernised plant elsewhere. In addition, pollution control equipment is mostly either absent or below standard. As a result there is a significant market demand/capacity imbalance in the basic subsectors:

Long products - substantial excess capacity

Flats - excess of demand over domestic production capability, currently satisfied by imports

VII.1.2 General market trends indicate that the passage of time will exacerbate these imbalances - see below.

VII.2 General market trends-

VII.2.1 Although there is no single reliable source of statistics, it is possible, based on GDP forecasts and trends in steel consumption and developments in the principal steel consuming sectors, to estimate the general size and growth of the Polish marketplace for the next few years and to assess the market demand/capacity relationship. The significant factors are market growth and new product supply sources which might enter the market due to capacity expansion and imports.

VII.2.2 *As far as market growth is concerned,* on a macro level, Polish GDP growth in 1995 was 7%, but it appears reasonable to consider that the growth will taper down progressively. Industry forecasts assess that GDP growth will reduce to about 5% in 2000. Because of the pervasive nature of steel within Polish industry, steel consumption should grow at a similar rate. However, on top of this market growth, there is a latent demand within the marketplace, best estimated based on consumption of steel per capita. In Poland, the current consumption of steel per capita approximates 0.14 tonnes pa, whereas in Western Europe the corresponding figure is 0.3 tonnes pa (in the Czech Republic - 0.23 tonnes pa). These macro statistics indicate that overall, steel consumption could grow faster than Polish GDP growth.

VII.2.3 In addition, a significant impact on steel consumption could be made by government sponsored sectoral programs.

The most significant macroproject currently underway in Poland is the Motorway project. This envisages the building of up to 2500 kms of motorway in the period 1996-2006 at a cost of USD10-12 billion. The impact of the program on the consumption of steel has not been evaluated, but is likely to be significant. The motorway program will increase significantly the consumption of steel bars and grids used as reinforcing materials, girders (welded and rolled) for bridge and gantry construction and flat products used for the production of safety barriers.

Other significant government-controlled sectors are locked into politically-induced stasis. There are no plans to privatise telecommunications, petrochemicals are currently the subject of yet another "restructuring plan" (possibly the fifth in as many years), and there are only embryonic and piecemeal efforts to privatise the electricity generation sector. It is unlikely that there will be any short-term stimulus to the steel sector from these sources.

VII.2.4 Equally significantly, perhaps due to market pressures caused by the enormous influx of imported motorcars immediately after the lifting of political and trade barriers in

1989, the motor vehicle production sector has largely become private. All Polish passenger car producers are now in effect privately-owned (FSO-Daewoo and Fiat-Tychy), and most of the major manufacturers are represented via existing (GM, Ford, Volkswagen, Peugot) or planned (Hyundai, Toyota) assembly plants. For many of these plants, the next logical move is to commence partially, the manufacturing of components in Poland.

VII.2.5 According to company announcements, the following motor vehicle manufacturers have made or plan major assembly/manufacturing investments in Poland:

Manufacturer	Nature of production	Total investment USD(000,000)
Daewoo	Assembly & manufacture	1,600
Fiat	Manufacturing	950
Ford	Assembly	60
General Motors	Assembly & manufacture	400
Hyundai	Assembly	50
Peugot	Assembly	20
Toyota	Assembly	N/A
Volkswagen	Assembly	30

In the context of these developments, the demand for good quality galvanised sheet steel for the Polish car industry is likely to explode in the near future.

VII.2.6 However, what is not clear is the extent to which the introduction of new, more material-efficient technologies might supplant the traditional use of steel in application such as building products etc.. Clearly, these substitute products would reduce the demand for steel, and the effect may be significant. There is no data available in this regard.

VII.2.7 In summary, most commentators agree that growth in steel consumption in Poland will be confined to flat products, and in particular to the following product segments/with the following trends:

Hot rolled coil - the trend is towards thinner gauges, down to below 2mm to perhaps 1.4mm;

Cold reduced coil - a growing market demand for better surface quality finish;

Value-added coated products - this is the area of greatest potential growth and also the greatest possible revenue-earner. Market potential exists in Poland for supplying new canning lines (based on double reduced tinplate), for pre-painted galvanised steels and for high-quality automotive steels.

These trends will deepen the need for a fundamental restructuring in the structure of Polish steel production, as currently, the productive capacity available cannot provide either the quantity or the quality required by the current domestic demand, let alone the future.

VII.2.8 By contrast, it is considered that demand in long products will remain steady.

VII.2.9 *As far as capacity is concerned*, the current available capacity for long products and for products which are sold "by the kilogram" is in excess of the needs of the Polish marketplace. The nature of these products, with their low value added and high transport costs (as a proportion of price) mostly restrict their natural export markets to places within sensible transport distance of Silesia (where nearly all of the Polish steelworks are located). Thus, the largest importer of Polish steel products is Germany, and the Czech Republic is also significant. However, Poland also exports significant amounts of steel to Taiwan, Thailand, Hong Kong, Morocco, China, Algeria, Great Britain, Korea and the USA. Ability to export to neighbouring states is hampered, in western European markets, by Eurofer restrictions and informal or formal EU monopolistic practices. In the East, there is ample supply of similar products at lower cost. Thus, in this segment, much export trade is based on government contracts, special credit arrangements, barter or exchange agreements and the like.

For sheet steel, the situation is entirely different. Domestic production of sheet steel is confined to one steelworks (Huta im T Sendzimira - "HTS") which even now has difficulty in meeting demand, despite the fact that the quality of its product is well below market standards. The production of processed (galvanised, coated, grain-orientated) sheet steel is dependent on this single domestic source, and the excess of demand over supply is being met from import sources (Koszyce, Thyssen, British Steel and others). HTS would like to increase its capacity for the production of sheet steel, and to improve the quality of the existing production, but is constrained by an inability to raise the necessary investment funds for this purpose.

VII.2.10 In line with previous conclusions, not only will the general market trends exacerbate the existing imbalances, but there is unlikely in the near future to be any new additional capacity coming on line where it is needed in the production of sheet steel.

VII.2.11 *As far as imports are concerned*, one of the most significant factors impacting the presence and position of Polish steelworks in the domestic marketplace is likely to be the impact on the prices they can charge, of the progressive reduction of customs duties and import tariffs on steel products imported into Poland, agreed as part of the WTA discussions. The tariff reductions are complex, but comprise four elements:

i) a general reduction of the current 1996 tariff of 17.8% for steel products to 12% in 2001;

ii) the accelerated reduction of duties for imports from EC countries (down to 0% by 1999, from 8.8% in 1996);

iii) the setting of import tariffs for CEFTA members at 50% of the base rate tariffs, with a complete elimination of duties from 1 January 1997;

iv) and by the reduction of the so-called "special import tax" to 3% in 1996 (from 6%), leading to its complete withdrawal in 1997.

The likely effect of the progressive removal of these barriers will be to increase price and quality pressures in the Polish marketplace, in the first instance, from Czech and Slovak suppliers, and this has started to happen for the first time this year. However, it is probable (but not certain) that the Polish government will invoke a "stay-of-execution" clause with the WTA which permits the delay (for up to 5 years) of the tariff reductions, and if this is done, the effect will be slow and much easier to cope with.

VII.2.12 Clearly, the progressive planned removal of tariff barriers is likely further to disadvantage domestic steel producers.

VII.3 Sector structure-

VII.3.1 There are 26 steelworks (see ATTACHMENT I), although a number of them are steel processors, rather than steel producers. Only two steelworks have been privatised to date (Huta Warszawa/Luccini and Stalproduct).

VII.3.2 For convenience, the Polish steelworks might be divided up by product segment into producers of long (and commodity) products, producers of sheet steel, and processors.

i) Long (and commodity) products

Significant producers are: Huta Katowice
Ostrowiec
Pokój
Cz_stochowa
Batory
10+ others

There are many producers in this category. The largest ones have realised that in this commodity business, the required competitive edge is price, and as a result have focused

on installing new, efficient plant (continuous casting lines). For most, the problem in realising investment programs has been the absence of funds or mechanisms for raising them. The most effective instrument of fund generation has been political pressure, either via the unions or through local politicians, and as a result, the smaller steelworks have lost out.

ii) Producers of sheet steel

There is only one indigenous producer of sheet steel, HTS, although there are a number of sheet slitters (flat plates have been included in section i), above). Because of the barriers to entry presented by the high capital costs involved in entering production in this segment, it is unlikely that any other Polish steelworks will be able to compete in this domestic market for a considerable time. Hence most of the new demand for flat steel products (and most of the new demand will be in flat steel products, not long products) will go either to HTS or to imports. Therefore, HTS is concentrating on matching import quality standards (which requires some very large capital expenditure).

iii) Steel processors

These are producers of value-added steel products, for example:

Painted and/or galvanised sheet	Huta Florian
Grain-orientated sheet	Stalprodukt
Welded wide bore pipe	Huta Ferrum

In the main these producers do not produce steel (although they may have done so in the past), but have restructured downstream, and as a consequence, may source raw steel from domestic or import sources. Most of these producers have developed or discovered a market niche within the domestic market (and in some cases, wider), and are showing signs of healthy development.

VII.3.3 Thus the Polish steel producing sector is highly fragmented in terms of productive units, most of which are owned by the State. However, this apparent common ownership did not make it easy to control the steelmaking SOEs, as under the SOE legal entity format, the owner has very little say in any aspect of the functioning of the entity. Additionally, until recently, there was neither the practical legal ability, nor the political will to force large SOEs to do anything against the will of the management or workforce. In other words, **it has never been possible to impose solutions on these big industrial employers, and this is likely to continue to be the case.**

VII.4 Stalexport-

VII.4.1 Stalexport S.A. is the only publicly-quoted Polish entity trading predominantly in steel, steel products and related raw materials. Stalexport, which is quoted on the main

market of the Warsaw Stock Exchange, has a market capitalization of 309 million Pln; the shares trade currently on a P/E of 10.7x.

VII.4.2 Originally, Stalexport was a State-owned Foreign Trade Organisation, which under the previous system, had the monopoly right to import and export steel products. Stalexport was privatised in 1994 by public issue and quotation on the Warsaw Stock Exchange. Now, Stalexport has stated its intent, by the year 2000, to capture up to 40% of the Polish market for steel products, and to integrate vertically its trading business with the production of steel, so as to control some 25% of Polish production in this sector.

VII.4.3 The largest market for Stalexport's export sales has historically been Germany, closely followed by Holland. Together, these account for over 55% of the company's export sales; products sold include all of the steel output of Poland - profiles, bars, semis and flats. However, Stalexport is only an intermediary, and steelworks are increasingly developing their own sales agencies and moving away from using the services of Stalexport. Only in those instances where steelworks are financially weak, or small, or where Stalexport has some other advantage to offer (as eg., deferred payment for imported goods or raw materials), or where a long-term agreement exists, can it be said that Stalexport has a raison d'etre.

VII.4.4 Stalexport is also a significant importer of iron and manganese ores, and other products. No information is available about this strategic positioning; however, Huta Katowice is investigating the possibility of constructing a docking facility at the Polish port of Gdynia, designed to handle deep draught transporters shipping ore from Brasil. This must be interpreted as an attempt to break the supply monopoly of Russian-sourced ores.

VII.4.5 Huta Katowice is Stalexport's most significant supplier and customer, particularly in exports and imports, as follows:

	1994	1995
Products of HK as % of Stalexport sales		
- proportion of total sales	38%	34%
- proportion of export sales	64%	54%
Supplies to HK as % of Stalexport imports	28%	32%

VII.4.6 Stalexport has also signed long-term supply agreements with a number of other steelworks, including Huta Andrzej, Huta Ostrowiec and Huta Pokój.

VII.4.7 In conclusion, it seems inevitable that the position of Stalexport needs to be considered in any privatization process involving Huta Katowice because of the evident existing strong trading links between the two entities. Prima facie, it would appear that Stalexport can offer an ability to access funding from equity sources via the (Polish) market. However, the respective values of the two entities are likely to be disproportionate.

VII.4.8 In order to consider further this promising connection, we consider that it would be useful to:

- o discuss with Stalexport their view of the situation;
- o assess the relative values involved;
- o consider the possible financial engineering which might be applied to reduce equity risk commensurate with reward;
- o take soundings of market institutions.

and assess some probable quantification of the possible shape of such a privatization transaction.

VIII. PRIVATIZATION STRATEGY ISSUES:

VIII.1 A question of approach-

VIII.1.1 A number of studies and reviews of the Polish steel sector have been performed. All have attempted to assess the future balance of supply and demand on a top-down basis. While such forecasts of supply and demand might provide workable outputs in a stable market situation, history has shown that in the rapidly changing Central European environment this form of analysis does not adequately reflect the dynamics of the situation (evolution of markets, evolution of management skills, risk-taking by investors, political acceptability of proposed action, strategic issues).

VIII.1.2 The Canadian Consortium plan, prepared in 1991/92 on a basis of earlier data, measured the performance and potential of the Polish steel industry at the nadir of the recession. Hindsight has shown that it was over-pessimistic in its recommendations in that it underestimated the speed and ability of the Polish economy to recover from the shock of transformation. The closures and consolidations recommended in the Canadian plan were never implemented because of resistance from the individual enterprises concerned even though the Polish government had a large World Bank loan for this purpose.

VIII.1.3 In March 1996, the Ministry of Industry and Trade officially rejected the Canadian plan. Instead, each individual steelworks was instructed to prepare its own

strategic business plan. We consider that this step will lead to a restructuring/privatization solution which is likely to be much more market-orientated, flexible and capable of implementation than the monolithic approach proposed hitherto.

VIII.1.4 We have echoed this Ministerial approach in our approach to the sector. Instead of restricting ourselves to the quantitative analysis of current (and guessed future) demand, we have adopted an approach to this report which focuses on the hurdles which might confront sector enterprises as they move to implement their strategic business plans in Polish market conditions. These hurdles include organisational issues, privatization and other Polish legislation, the availability of capital, employment and social aspects and the feasibility of implementation under Polish conditions.

VIII.1.5 Our approach is based on:

a) an assessment of the current sector situation and definition of sector objectives;
b) a consideration of the potential hurdles to be overcome in the process of achieving sector objectives.

We have formulated the recommendations set out in Section IX regarding the approach to sector privatization based on the above analysis.

VIII.2 Assessment of the current situation and definintion of sector objectives-

VIII.2.1 The Polish steel sector is highly fragmented, with 26 or 27 steelworks employing about 92,000 individuals, most of which are located in one area threatened by high unemployment. Over the six years since the commencement of the transformation process, only two have been privatised. The rest are State-owned, but under the control of different State units; 4 are joint stock companies owned by the State but controlled by different NFIs, 9 are joint-stock companies controlled by the newly created (1 October 1996) Ministry of the State Treasury (or possibly the local *wojewoda*) and the rest are PPs (controlled by the Ministry of Industry and Trade). The global investment needs required to modernise the industry range are assessed at 4,500 - 6,200 million Pln. The aggregate losses of the Polish steel industry in 1991 amounted to a loss of 454 million Pln. However, many of these fragmented steelworks have shown great resilience in carrying out their own restructuring, largely based on their own internal resources. A number of steelworks have repositioned themselves away from steel production to value-added steel processing. The aggregate profits of the Polish steel industry in 1995 amounted to a profit of 340 million Pln.

VIII.2.2 The objective of the Polish government is to have a profitable, internationally competitive and environmentally-friendly steel industry in Poland. In addition, the government has determined that it must, for strategic reasons, support domestic steel production. Yet because Poland wants to join the EU, this domestic steel industry must compete within EU competition rules.

VIII.2.3 It is important to note that although the Polish term "*huta*" (steel smelter) features in the names of most of the sector enterprises, many Polish steelworks no longer produce steel. Some of the sector reports we have seen refer to the self-implemented closure of (open hearth) smelting facilities by 9 or 10 former producers. Although some of the closed facilities have been replaced by equivalent modern plant (eg Huta Cz_stochowa), others have been closed permanently (eg Huta Florian).

VIII.3 Potential hurdles to be overcome-

VIII.3.1 The potential hurdles are as follows:

- shortage of investment funds for modernization;
- the possibility of triggering social unrest;
- redundancies and social safety net issues;
- ineffective corporate governance mechanisms;
- organizational market adjustment;
- the question of management motivation;
- need to accord with EU competition rules;
- need to maintain domestic steel production;
- ecological issues.

VIII.4 Individual discussion of issues-

VIII.4.1 Shortage of investment funds for technological modernization

There is a substantial need for capital for investment in the Polish steel sector. The estimated costs of restructuring the Polish steel industry, as assessed by Ministry of Industry sources, are:

USD millions

New plant		1,650
Modernisation of plant	1,200	
Pollution control	750	
Social safety-net	300	
Debt forgiveness	550	
Total	4,450	

With a few notable exceptions, the government has not been able to provide this funding, even in connection with the provision of the amounts required for the social safety-net aspects. Until recently, some financing has been provided by Polish banks under 60 percent Polish government guarantee. However, recent approaches to Polish financial institutions by the government have been met with a rebuff.

Suggestions have been made regarding funding from sources other than Polish financial institutions. These include the creation of a special purpose government-run sectoral investment fund. The sources of financing of such a fund are unclear and could possibly include only international financial institutions. However, the World Bank as a rule does not finance restructuring of state-owned enterprises, and the EBRD and IFC are mainly interested in participation in privatization. In any case, any government control of such sources means that funds are funnelled through political rather than market channels, and are likely to succumb to political pressures. Thus any distribution of funds in this way is unlikely to be based on the market merit of individual investment proposals.

Funding of the process of change is essential, but the challenge is to design a funding mechanism which only distributes funding to viable business prospects. Such a channel can only be from the private sector.

VIII.4.2 The possibility of triggering social unrest

In all cases the steelworks are substantial employers. The biggest employers, in order of size, are:

Huta Katowice SA		20.0
Huta im T Sendzimira		17.5
Stalowa Wola SA	14.7	
Huta Cz_stochowa		7.8
	60.0	
Others (per Attachment 1)		32.0
Sector employment	92.0	

All of the above (named) steelworks are state-owned, and are the biggest employers in their respective areas. By location, the concentration of employment in the steel sector is as follows:

Katowice/Gliwice area		39.1
Kraków	20.0	
Stalowa Wola		14.7
Cz_stochowa	13.2	
	87.0	
Others (per Attachment 1)	5.0	
Sector employment	92.0	

It is apparent from this distribution and concentration of employment, that a concerted effort at restructuring could have wide-ranging repercussions in a number of major industrial centres already threatened with job losses. In particular, employment in the Katowice/Gliwice area is threatened by the closure of coal mines, and the steelworks in Kraków and Stalowa Wola are the single largest employers in the area.

A wholesale approach to restructuring and privatization will aggravate the danger of simultaneous social unrest in a number of important industrial centres. On the other hand, a gradual, piecemeal approach would spread the impact and allow for a better social acceptance of the process.

VIII.4.3 Redundancies and social safety net issues

In all large Polish restructurings a major issue is the visibility to the workforce, as represented by the Unions, of the proactive creation of replacement jobs. At HTS, the creation of replacement jobs was a precondition to Union agreement to the strategic plan and involved the creation of the Kraków-East Development Agency, and similar negotiations have taken place elsewhere. It is significant to note that in this sector, such negotiations have taken place **and have been resolved** on an enterprise-by-enterprise basis rather than at a pan-sectoral level.

Despite the concensus at central government level of the need to support the restructuring efforts of steel sector enterprises in connection with redundancies, ie., retraining, severance payments, early retirement incentives and so on, there has not been created any coordinated governmental program which might be used by all enterprises. Neither has

there been prepared any specific formula of eg., tax reliefs which might cushion the cost of redundancies and fund the creation of replacement jobs.

It seems clear that a major factor hampering the reduction of employment in the industry is the additional burden that is placed on sector enterprises because of the absence of a government-provided social safety net. Provision of a visible program of job creation from the centre would improve the individual enterprises' ability to conduct restructuring.

VIII.4.4 Ineffective corporate governance mechanisms

Control over sector companies is widely spread. The sector is fragmented, with 2 private steelworks, and 25 steelworks under the control of different public sector bodies; 4 are joint stock companies owned by the State but controlled by different NFIs, 9 are joint-stock companies owned by the State and controlled by the Ministry of the State Treasury and the rest are PPs (owned by the State) and controlled by the Ministry of Industry and Trade. Of these PPs, some are managed under the so-called Management Contract formula (for example, HTS), and others have the more usual legal formula of "triangular management" by the Founding Organ, the Director, and the Workers' Council.

The ability of the owners (in the majority of cases, the State Treasury in its various representations) to control the enterprise, is poor. Practically, the State as owner can only exercise negative control -that is, it can refuse to guarantee loans from the bank. In most other areas, the enterprise can pursue its own course of action without sanction, including not paying over to the State Treasury taxation (VAT, PIT) or social security contributions (ZUS).

For the above reasons, any centrally-administered plan of rationalization, restructuring and eventual privatization would be difficult to implement.

VIII.4.5 Organizational market adjustment

Six years after the start of market reforms, the majority of Polish steelmills still have a structure of a state-owned enterprise. A transformation into a state joint stock company, which is supposed to be accomplished for all steelworks by the end of 1996, defines the legal and ownership structure of the company. However more extensive organizational changes are needed to further adjust the company to market conditions. The biggest Polish steelworks, Huta Katowice and Sendzimir, have already started this process. It consists of spinning off service entities and niche activities to isolate the steel production entity and create a more transparent structure. This combined with the establishment of

modern financial systems and cost accounting, leads to a possibility of lowering costs of production in particular areas.

In addition to making the steelworks more efficient, their large size is divided into logical, smaller parts which create a possibility of private investment into these smaller, better defined companies. This direction is worthy of further pursuit.

VIII.4.6 The question of management motivation

Experience in Poland indicates that the most important factor which creates the climate for change within enterprises is the creation of a credibly achievable target together with the installation of achievable motivation mechanisms for key individuals. Even given the uncertainty surrounding the shape of the sector, and the general lack of attention to individuals prevalent in the social climate, there has beem a remarkable absence of such mechanisms in the sector thus far. Yet these elements are the keys to unlocking the potential inherent in individual enterprises.

For example, the initial work on the restructuring of HTS was based on an approach which involved changing the attitude of the key influencers/decision makers. Those individuals were pulled out of the SOE environment, and set to work to identify and list the (seemingly impossible to solve) problems that were facing HTS, priorise them and then try to create solutions. Thereafter, it was down to the individuals to infect others at HTS with the vision of the solution. In this way, the logjam of different and in some cases, opposite, views of the future was removed, and the process of restructuring of the steelworks commenced.

While the vision of the future at a given enterprise might be the goal, the achievement of this goal should be also rewarded. The individuals working to restructure a given enterprise need to be motivated, supported and retained, since they will be pushing against a great inertia.

At a recent very successful Polish restructuring, the vision was market dominance and privatization to gain capital and enable development, and the reward was management participation in the equity. This enabled six years of hard work, with a net profit progression from USD3 mln (loss) in 1991, to an expected USD6 mln profit in this year, and flotation on the WSE (Stomil Sanok SA). The management should become significantly wealthy as a consequence.

We strongly support the principle of letting Polish managers devise Polish solutions for Polish problems, while at the same time exposing them to information regarding how such problems were solved elsewhere and rewarding them for results actually achieved. Such a

mechanism should be an integral part of the process methodology used to restructure the Polish steel sector.

VIII.4.7 The need to accord with EU competition rules

In assessing the privatization strategies for the Polish steel sector, it is important to understand the approach of the EU to industry competition issues in order to understand the nature of the pressures that will be brought to bear on the sector after the accession of Poland into the EU. An investigation of the approach of the EU to competition issues, both explicitly and in practice, needs to be made to determine the likely attitude of the EU towards the sector. The EU steel sector is considered to have excess capacity and formal and informal agreements appear to have been made regarding closure of EU steel making capacity and establishing import quotas among EU members. However, as the steel making capacity of the EU is not wholly privatized, many believe that demonstrated decision making within the sector is not necessarily wholly commercial.

Poland should seek to define clearly the demands of the EU as they relate to the outcome of the eventual harmonization of competition rules in this sector (ie., conditions as at the date of entry to the EU). These conditions precedent relate fundamentally to the abolition of tariffs and quotas over an agreed time-span. We consider that the question of the reduction of capacity should be relegated to a secondary position, as long as the maintenance of capacity is not the subject of government funding or support.

In this way, providing that fair competition is assured through the absence of tariff and non-tariff trade barriers and there are no subsidies, the level of capacity within the Polish sector will in the medium term be determined by market conditions and pressures, and is diminishing naturally anyway. The principal question to consider and negotiate is the period of time over which tariffs and quota limits between Poland and the EU will be eliminated on a reciprocal basis. This period of time should be sufficient to allow for Polish steel producers to restructure, so as to be able to compete on a fair and complete basis with EU producers. Since such restructuring takes not only time but also requires investment, and since funds for investment are not available and should not be provided from State sources, the privatization of the sector should also be completed within this time.

We do not believe that this approach precludes the government providing safety-net funding to cover the social costs of restructuring.

VIII.4.8 The need to maintain domestic steel production

Until the Polish steel sector is fully privatised, the EU will remain concerned about its capacity and investment programs. This will create issues in negotiating accession that would not exist if the sector is privatized prior to Polish entry into the EU. Therefore, the synchronization of the privatization program of the sector with the progressive abolition of barriers and harmonization of trading conditions should largely allievate EU concerns regarding excess capacity and unfair trade following accession.

We suspect that in part, concern regarding excess capacity arises in substantial measure from an out-of-date perception of the Polish steel sector, based on superseded data. Today, it seems clear that the Polish approach to the steel sector does not need to be as defensive as might have been thought just a few years ago. Demand in Poland appears to be much healthier than once anticipated, even in the context of a global market which is also healthier than expected. This positive outlook in the domestic and global markets appears to be sustainable across an intermediate term sufficient to justify investment in appropriate capacity, particularly in the flat products segment.

Furthermore, the EU should not be considered the only or even principal determining market for the Polish steel sector, as export potential in the global markets is real and recovery in CEFTA/CIS/NIS markets only a question of time. It would appear that the conclusion of the Canadian consortium report, that Poland should concentrate only on capacity for its own market is conservative.

In our view, the Polish approach to steel sector EU integration should distinguish between three separate markets;

long products, where there appears to be excess capacity which given privatization, will be tested by the marketplace;

flat products, where there is a shortage of capacity and where investment to reach quality standards is justified by market opportunity;

and on-processing of steel, which should be entirely excluded from these discussions.

In our view, Poland should seek to retain as much of its productive capability as is justified by the market - in other words, Poland should negotiate on abolition of trade barriers on a reciprocal basis while privatising the steel sector over an agreed time horizon, and simultaneously rely solely on internal market pressures to force appropriate capacity changes.

VIII.4.9 Ecological issues

Although the level of atmospheric pollution, waste and water pollution, and other degradation of the environment was very high in the late 1980s, the substantial drop in the level of production in the 1990s, together with the much increased emphasis placed on this area, has played a major role in reducing levels of pollution. Some of the worst offenders have been closed, and the resulting improvement in the quality of the environment is noticeable in cities like Kraków and Katowice.

While still a significant area, the question of pollution is now at a secondary level.

IX. PRIVATIZATION STRATEGY:

IX.1 A question of objectives-

IX.1.1 The Polish privatizaton policy has as its main objective the maximization of profits for the state budget which funds extensive social programs. However, this criterion cannot apply in relation to the steel sector, and probably other heavy industry sectors, where the depth of restructuring and the strategic requirement for a largely indigenous industry preclude the privatization of the steel sector from being a major fund raiser for State Treasury purposes. Hence, the cardinal objective to be achieved in the process of restructuring and privatization is a strong and viable Polish steel industry.

IX.1.2 In order to achieve this objective, the infusion of large funds is required, both for investment purposes at the level of each individual enterprise, and also pervasively, in order to create a social safety-net.

IX.1.3 Thus, the privatization of the industry should proceed enterprise by enterprise, each constituting a step in the restructuring process of the sector as a whole, enabling each enterprise to access private sector funds by preparing and presenting its own concept of development on a normal commercial basis. The privatization strategy of the steel sector should consist of four separate processes:

1) in-enterprise restructuring to spin off viable divisions, define costs, and separate core business

2) creation of an employment policy for excess employees;

3) investments into spun-off companies by professional financial institutions, judging and filtering each proposal on its commercial merits;

4) privatization of the core companies through an IPO on the stock exchange or sale to a strategic investor.

IX.2 In-enterprise restructuring-

In this process the enterprise plays the principal role. The objectives of in-enterprise restructuring are the creation of commercially viable businesses.

We envisage that the process might take the following path:

a) capture domestic market by spinning-off market orientated niche steel processing operations, which should be capable of attracting private sector venture type funding on their own merits. Accordingly, these spin-offs should be done on a joint venture basis with financial investors, and if properly constructed, will yield funds for the enterprise which can be used for restructuring purposes;

i) the above spin-off may be performed without any amendments to existing legislation;

ii) spin-offs should be encouraged by tax relief for the parent enterprise based on the employee headcount reduction achieved;

iii) spun-off enterprises function in a full market environment, and are able to source and sell at will;

iv) the parent enterprises may gain funds from the spin-off which can be used for restructuring investment.

b) The parent enterprises are shorn of their value-added production, other than in so far as they own equity in the spun-off subsidiaries. However, they may continue to supply raw material, providing the supply is competitive on an arms' length basis.

c) This process should guarantee the creation of strong, domestic, value-added steel processors, controlling the domestic market.

d) This process will also bring to bear market pressures (in accordance with the tariff reduction program) on the parent enterprises. Some of the parent enterprises may find that they are unable to compete because of their cost structures. These will be eroded away in a

natural economic way, and ultimately will either be sold (presumably to trade buyers) or closed via liquidation. In this way, non-viable producers wither away, thus capacity is reduced and production concentrated at the main producers.

IX.3 Job creation for excess employees-

In order to generate new jobs in Silesia, an area threatened by high unemployment by excess employees from the coal-mining and steel industries, the Polish government created a special economic area near Katowice-Gliwice townships. However, this area still does not have a full legal framework and its sole concession is the abolition of income tax for ten years, and its reduction afterwards. It is not clear, whether it will be enough to generate a lot of foreign investment necessary to create jobs for redundant workers.

In order to evaluate the Polish concept of special economic area, we suggest to compare it with regulations for very successful Special Economic Zones in China which provided jobs for millions of the Chinese. These SEZs are created especially to accommodate foreign investors and have special political and administrative structures. There are four chief sets of regulations which distinguish Chinese SEZs from the regular economy:

First, they have a special tax and customs regime. Enterprises pay 15 percent tax (in relation to 30 percent regular tax). Profits reinvested for five years or longer are exempt from tax. All investment goods brought into a zone are exempt from import duties.

Second, a simplified business regulatory regime applies to SEZs. This includes a suspension of the local labor law in favor of labor contracts.

Third, a Western level business infrastructure, including telecommunications, is provided or contracted by private entities to be provided, to foreign investors;

Fourth, foreign banks and insurance companies are allowed to operate to service foreign investors in addition to local ones.

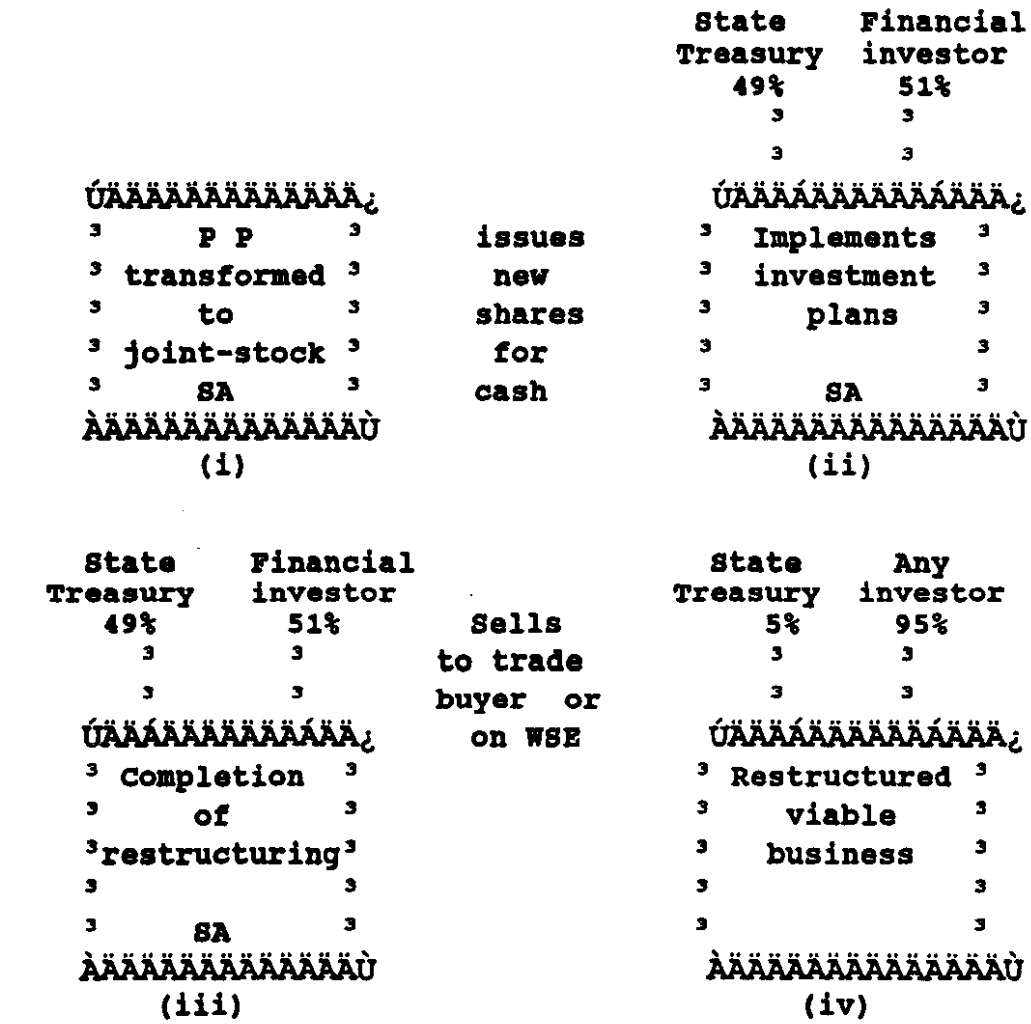
Currently, the above tax privileges have been extended throughout China but foreign investors still mainly invest in SEZs because of the superior infrastructure.

In addition, in Poland, attempts have been made to create additional workplaces in the steelworks threatened by excess employees by securing funds from the government which would have been spent on unemployment insurance. While such actions have no basis in the current law, an effort should be made to investigate possibilities of such job creation programs.

IX.4. Financial investments in spun-off companies

The well-managed spin-offs, privatized by employee-leasing or wholly owned by a mother company could access additional funding from financial investors through dilution of share capital, rather than by sale of equity.

The overall schematic of privatization process might be as follows:



The above process applies equally at whole-enterprise level as well as at within-entity level (spun-off enterprises).

This process is already being spontaneously and successfully implemented.

We envisage that the main engines driving this process will be the enterprises, who will want to access investment funding. This process has already started in a number of enterprises (Stalprodukt), and we consider that it is capable of leading to a rapid privatization of the most viable parts of the steel sector, without loss of value by central government, without provoking social unrest, without requiring the provision of funds for investment purposes by the government and without breaching EU competition rules.

Furthermore, an organizational structure based on a group of subsidiaries seems to be a trend, followed in many successful Western steel companies.

IX.5 Privatization of the core company

As a direct consequence of this process, the core steel companies, concentrating on lowering their costs and improving their efficiency, might become attractive candidates for privatization. The main steel producers are monitored during the spin-off process. If they are capable of stand-alone survival, they may be offered for sale via the Stock Exchange, or otherwise (in this connection, reference should be made to the potential offered by the Stalexport/Huta Katowice combination). If they are struggling, they should be offered to trade buyers.

IX.6 Government support for restructuring and privatization-

IX.6.1 It is unrealistic to expect the Polish government to lead directly the global restructuring of the steel sector. All attempts in this direction have proved impossible to implement. The only part of the activity of the sector which has been substantially controlled by central government has been the grant of government guarantees for funding.

IX.6.2 Instead, the Polish government should focus on the provision of enabling factors, designed to sponsor in-enterprise restructuring and the infusion of private capital, such as:

- maintain an agreed (but finite) period of domestic market protection, with a progressive transition to EU rates and conditions;

- ensure that only viable investment is made by avoiding the granting of government guarantees, thus switching the provision of finance for restructuring investment to the private sector;

- depoliticise the injection of funding, decentralise and market-orientate sector investment by encouraging the creation of "privatised" joint-ventures by individual steelworks, for niche operations, with the equity participation of financial investors (spun-off subsidiaries);

- improve the steelworks' ability to fund the creation of replacement jobs by creating tax relief in the form of a per capita allowance per job reduction achieved, 100% offset against any form of taxation payable (VAT, PIT, CT) by the individual steelworks;

- create a special economic zone for a large part of Silesia which provides the full business environment that foreign investors need, not just tax relief, to create jobs in a potentially explosive area;

- improve the power of management by contracting the services of managers under the Polish management contract scheme (*kontrakt menad_erski*)

- provide significant share incentives to groups of top management.

IX.6.3 In summary, Government policy should:

o determine the time over which Polish industry should achieve market acclimatization;

o support in-enterprise restructuring;

o avoid any form of direct government financial support for individual steelworks;

o allow market conditions to pressure the large steel producers to evolve progressively to meet market demands;

o give greater support to ventures creating alternative employment by giving concessions to private investors to create the physical and financial infrastructure necessary for foreign investment.

IX.6.4 In the light of the above, the future direction of privatization of the steel sector should avoid any direct centrally imposed attempts at rationalization and consolidation. All such attempts, since 1990, have proved unworkable; similarly, in the future, such attempts are unlikely to be capable of implementation and may create additional threats to restructuring and privatization.

IX.7 Other possible privatization strategies-

IX.7.1 We see three other mechanisms which might be contemplated:

a) holding company structure

b) sell immediately to a strategic trade investor

c) do nothing option.

a) holding company structure:

The central holding company structure is a sensible theoretical model, applied practically with success in the United Kingdom, inter alia.. In our view, in Poland, the centrally-imposed consolidation of the industry under one holding company structure is unworkable, as history has proven. The imposition of a solution from the centre requires a great deal of political will and a strong unified government, as well as substantial sums of social safety-net funds. Neither of these fundamental conditions exists in Poland.

Indeed, we consider that the creation of a holding company structure in Poland would significantly damage the ability of the sector to restructure. It would create a monolithic employer of labour, which would work against job reductions and would encourage concerted strike action. Under the existing circumstances, creation of this additional threat would be undesireable.

b) sell immediately to one or more strategic trade buyers

This option is workable, but only assuming that suitable trade buyer(s) can be found for the whole of the Polish steel industry. This is unlikely, since interest hitherto has been expressed in the better parts only. If the better parts are sold in this way, then the remaining parts of the Polish steel sector will be automatically condemned to failure.

There are also further issues relating to the creation of monopolies; for example, the sale of a "package" of steelworks which dominate a particular sub-sector may create an undesireable monopoly situation (with consequent *Urz_d Antymonopolowy* problems).

In addition, the price which might be obtained now is likely to be significantly lower than the value which might be created as a result of the restructuring process.

Consequently, we do not believe that this option would be acceptable to the Government.

c) do nothing option

Inaction on the part of government will lead to the inability of Poland to join the European Union within a reasonable period of time, or to compete effectively, thus contributing to the possible demise of the Polish steel industry. Starving the steel sector of investment capital will prevent its modernization and the development of production of a new assortment of steel products, demanded by the domestic industry. This will allow foreign steel companies progressively to dominate the domestic market. The lack of a more effective effort to solve the problems of excess employees will create resistance to the needed restructuring and a greater dependence on the government welfare programs, which are already overburdened.

ATTACHMENT I:

MAJOR POLISH STEEL SECTOR COMPANIES

	Synopsis of product offer	Legal form & ownership	Turnover millions Pln no employees
Andrzej	seamless tubes railway tracks	PP (State)	180 2,900
Baildon	rods and bars of special steels forgings rolls for rolling mills strip and sheet steel of special steels drills	PP (State)	180 3,200
Bankowa RS	billets, bars channels, railway wheel rims	SA (H Katowice)	127 2,334
Batory	thick section (6-150mm) hot rolled plates seamless tubes forged rods & bars	SA (State)	214 4,500
Bobrek	liquidated		
Buczek	seamless steel tubes profiles seamed tubes rolls for rolling mills	SA (State) IV NFI	89 1,760
E Cedler	wire rod and bars cold rolled strip steel angle profiles	PP (State)	407 1,720
Cz_stochowa RS	seamless tubes thick section (5-40mm) plates	PP (State)	597 7,850
Ferrum	welded steel pipes containers	SA (State) NFI I	85 1,560
Florian	rods and bars strip and sheet steel galvanised HDG/organic coated profiled sheet	PP (State)	386 2,700
HTS RS	cold rolled sheets (0.22-2.5mm), black electro galv sheet, tin (0.22-0.5mm) zinc (0.5-1.5mm) hot dip galv sheet, zinc (0.5-2.5mm) profiled sheet hot rolled (2-12 mmm), incl impressed strip steel seamed tubes rectangular and angle sections reinforcing rods	PP (State)	1,711 17,540
Jedno__ RS	seamless tubes fittings	SA (State)	? 2,500
Katowice RS	I, T, C section RSJs railway and tram rails angle girders slabs, blooms and billets	SA (State)	2,400 22,690

		Legal	Turnover

	Synopsis of product offer	form & ownership	millions Pln no employees
Ko_ciuszko	rails and RSJs rods and bars	SA (State)	17 2,500
Lab_dy RSMini	thick section (5-40mm) steel plates bars	? (State)	230 1,800
_aziska	ferroalloys	? (State)	? ?
LW RS	rods and bars strip steel rolls for rolling mills	Sp z OO (Private)	425 2,600
Ma_apanew	rolls for rolling mills wheels	SA (State)	82 3,290
Ostrowiec RS	rods and bars thick section (100-600mm) steel plates shafts and rolls	SA (State)	? 5,400
Pokój	sections thick section (5-32mm) plates RSJs and angle sections	SA (State)	150 2,230
S Wola RS	rolled & forged bars springs	SA (State)	403 14,700
Silesia	pots, pans galvanised barrels radiators	PP (State)	41 1,600
Stalprodukt	grain orientated sheet motorway barriers profiles	SA (Private)	168 2,239
Zawiercie RS	rods and bars angle profiles	PP (State)	445 4,331
Zabrze	wheels	SA (State) IV NFI	23 1,700
Zygmunt	forgings	SA (State) XV NFI	? 1,800
1 Maja	axles and bogeys	PP (State)	25 880

Notes re data

Turnover figures are for 1994, except LW & Ko_ciuszko, which are 1995
Employee data is for 1995
Legal status is "as at" date of writing
- PP = "przedsi_biorstwo pa_stwowe" - state-owned enterprise
- SA = joint stock company
- NFI = state-owned company managed by National Investment Fund

RS = producer of raw steel
e = estimate
? =not disclosed

ATTACHMENT II:

OVERVIEW OF HUTA im T SENDZIMIRA

AII.1 Production at Huta im T Sendzimira ("HTS")-
Total 1995 steel product sales were 2,348,000 tonnes.

AII.1.1 Fully integrated production takes place at one site at Nowa Huta. The works were constructed in the period 1949-1954 on a greenfield site near Kraków. The site area, including the so-called "protective zone" is over 2,000 hectares. The liquid steel output is currently targetted at 2,200-2,400 thousand tonnes pa or thereabouts.

AII.1.2 Key raw materials are sourced from the Ukraine (iron ore) and from local mines (coal for coking). There is a minority-owned subsidiary (Z_omex SA) which sources and supplies most of the scrap steel needed for steelmaking. Limestone is sourced from nearby mines in the Kielce area. Coke is made on site in five wet-quench coking batteries, of which two are at the end of their useful lives. Only two are in regular use. The quenching process generates much steam and smoke, and pollutes the air of Kraków. A new dry-quench coking battery is almost completed, but requires about USD19 million of capital spend to finish. This will reduce the environmental pollution problem.

AII.1.3 The steelmaking production flow is traditional in nature. 3 blast furnaces feed 3 steel-making converters, with a newly commissioned continuous caster now eliminating the casting of ingots. Thereafter, there is a continuous hot strip mill, two cold mills (one with the capacity to produce cold reduced tinplate and hot dip galvanised material) and an electrogalvanising line.

AII.1.4 The equipment installed is as follows-

Sinter plant - the plant is old and has a capacity of up to 2,600 thousand tonnes. This is sufficient for the planned demand levels up to the year 2000.

Blast furnaces - two blast furnaces are currently in use, of which one has been closed down for a reline which will be completed by the end of 1996. The furnaces are out-of-date, but improvements are to be implemented this year, including coal injection. Budget campaign life is 10 years. Given the improvements which are currently being implemented, capacity will exceed the 2,000 thousand tonnes pa of pig iron needed to support the production of the planned 2,200 thousand tonnes pa of steel.

Steelmaking plant - the plant has three top-blown converters with a liquid cast steel weight of 140 tonnes. The installation does not use combined blowing or sub-lance, but is sufficient to handle the planned capacity (total capacity approximates 3,000 thousand tonnes pa).

Continuous caster - this machine is state-of-the-art, and will handle in a continuous casting mode, the entire output of the earlier steelmaking plant. It was commissioned in May 1996.

1700mm continuous hot strip mill - this Russian-built mill is very old (completed in 1956), and is manually operated. The coils produced have a maximum weight of 10 tonnes, a minimum-maximum strip width of 700-1550mm, and a thickness of between 2-12.7mm. exit speed stands at 8.8m/sec. The mill comprises 6 reheat furnaces, 4 roughing stands, crop shears, 7 finishing stands and 5 coilers. The introduction of continuous casting should significantly improve the quality and performance of this mill, both in terms of capacity and unit cost. Following the introduction of continuous casting, capacity will be up to 2,200 thousand tonnes of hot rolled coil pa..

Cold mill 1 - this Russian-built mill was completed in 1958, and produces cold reduced tinplate and hot dip galvanised material. The line consists of two 1700mm sulphuric acid pickle lines, a 1220mm manually operated 5-stand tandem mill with capacity of 400,000 tonnes - cold reduced and 300,000 tonnes tinplate

feedstock, feeding two electrolytic cleaning lines and two temper mills (1700mm single stand and two stand), terminated by a coil preparation and inspection line. The 1220mm electrolytic tinning line has a capacity of 100,000 tonnes pa, and requires extensive updating and modernisation. The 1250mm hot dip galvanising line has a capacity of 120,000 tonnes pa. A relatively modest amount of capital expenditure would be needed to ensure product met market requirements. There is also a single stand reversing mill and one Sendzimir mill. Hot rolled coils (maximum 10 tonnes weight) are transferred from the hot strip mill to the mill complex by conveyor. However, the complex suffers from poor technical controls and inadequate handling and storage facilities, which cause damage to work-in-process, increase scrap and wastage rates to unacceptable levels, and impairs the quality of material sold.

Cold mill 2 - this Western-built mill was assembled during the 1970s and early 1980s, and produces cold reduced coil for sale and for the electrogalvanising line. The line consists of one modern Voest Alpine computerised 1700mm hydrochloric acid pickle line (the capacity of which is however limited by the acid recovery plant), a computerised IMI 1700mm 4 stand tandem mill, batch annealing, a single stand 1700mm temper mill and suitable cut-up and slitting lines. Coil handling capacity is a maximum of 30 tonnes, but these are not available from HTS.

Electrogalvanizing line - this was built by Italimianti in 1993, and fully commissioned in late 1994. It is modern, but requires some additional (modest) capital spend in order to improve quality (removal of ferrous staining and edge cropping) and enable it to supply car body steel at Western European standards.

AII.1.5 There is little pollution control equipment evident at any stage of the production process. The planned HTS modernisation programme (see below) includes an allowance for emission control equipment (at approximately 15% of total cost), but external opinion estimates that this cost will probably be higher.

AII.2 Investment needs-

AII.2.1 The investment (modernisation) programme for HTS is a serious future commitment for the steelworks, and for any incoming investor. In broad terms, the value of the investment required approximates USD225 million in the current year, with in excess of USD100 million in 1997 (in part, the exact figures depend on the achievement of this year's programme), and thereafter, a further spend of over USD300 million over the succeeding three years. The 1996 part of this programme is currently under way, and there have been some comments that the budget does not make sufficient allowance for the pollution control equipment costs (further amounts of up to USD55 million have been indicated). A more detailed breakdown is given below.

AII.2.2 The short-term modernisation programme includes (costs in millions of USD):

	Cost	Planned
Dry quench coking battery	19	1996
Reline of Blast Furnace 25	1996	
Coal injection	25	1996
Continuous casting	130	1996
Desulphurisation & oxygen	26	1996
Total current year	225	

At the time of writing, the continuous casting line has been completed and commissioned, and the reline of the blast furnace is under way. To the previous amounts should be added provision for environmental control equipment, which could approximate USD 40 and 15 million respectively in 1996 and 1997.

AII.2.3 The longer-range investment programme has to consider further capital expenditure. This must include:

Secondary steelmaking - BOS

Roll shop improvements in the Hot Strip Mill and replacement of the 4 (of 6) small capacity Russian reheat furnaces, installation of 25 tonne coil handling capability

Refurbishment of the 5 stand mill in Cold Mill 1 and improvements in materials handling

Removal of bottlenecks in the Cold Mill 2, acid recovery

The additional cost of these modernisations is likely to amount to a further USD113 million for spend identified for 1997 (see below), and thereafter, over the succeeding 3 years, a further USD300 million or thereabouts.

AII.2.4 In summary, the modernisation plan includes (millions of USD):

	Cost	**Planned**	
1996 spend, as previously itemised		225	
1997 spend-			
Steelmaking		50	1997
Hot strip mill modernisation		40	1997
Other		23	1997
Total 1997		113	
Longer-term spend	300	1998 - 2000	
Additional environmental		55	additional
Total capital spends		693	

This spend is entirely in respect of modernisation.

AII.2.5 This amount of funding cannot be sourced from cashflow internally generated by HTS over the next two years.

AII.3 Restructuring and Privatization at HTS-

AII.3.1 Huta im T Sendzimira is one of the largest Polish State-Owned Enterprises in the manufacturing field and the second-largest steelworks in Poland (after Huta Katowice). It is the largest single employer in the Kraków region, with a payroll of 17,540 and further employment of about 7,500 individuals in dependent (minority-owned) subsidiaries.

AII.3.2 The enterprise is a PP, managed under a "Management Contract" by a Chief Executive, Mr J Knapik (this form of management contract substitutes a supervisory board for the usual Workers' Council at the enterprise, and strengthens the ability of management to manage). The founding organ is the Ministry of Industry.

AII.3.3 In the mid 1980s, HTS was a vertically integrated steelmill, with a typical command economy structure. It had its own hospital, hotels, transport, toolshops, maintenance and rework facilities and so on. At that time, the whole of the enterprise employed nearly 35,000 individuals.

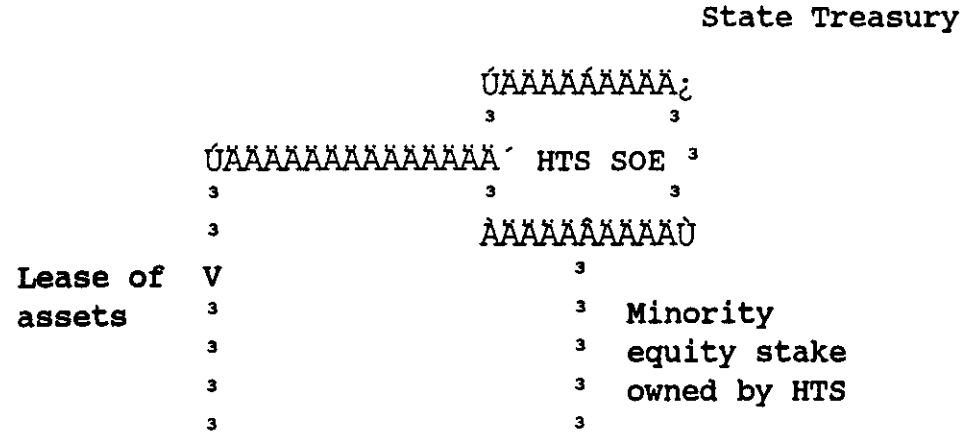
AII.3.4 HTS entered the 1990s overmanned, badly structured, over-borrowed and with excess capacity in the wrong productive departments. The fall in Polish finished steel consumption between 1986 and 1992 was closely mirrored by the reduction in HTS production from a peak of about 6 million tonnes down to 1.7 million tonnes in 1992. The financial results were correspondingly poor, and HTS generated significant losses. In 1993, HTS commenced a programme of restructuring, which included the retraining of top management, the spin-off of non-core businesses and the redeployment of surplus assets. This restructuring helped turn the 1992 net loss, into the 1995 net profit of approximately USD50 million.

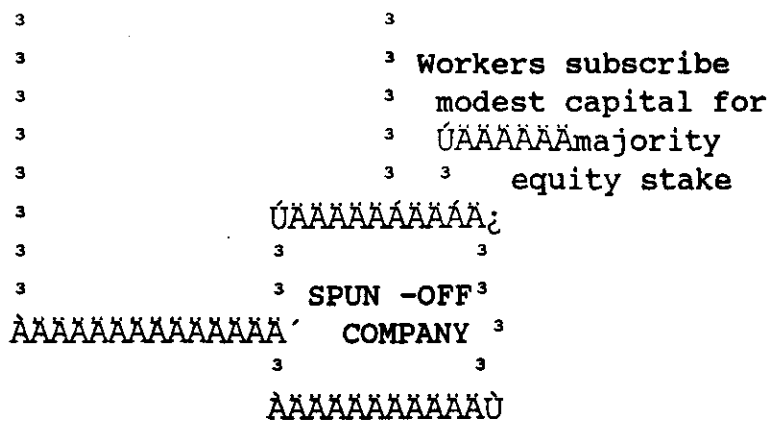
AII.3.5 To date, HTS has spun-off into private hands 8 larger companies, as well as a number of smaller entities. These include the following:

- o Stalprodukt - manufacture of electro-steels
- o PMO - refractory materials
- o Z_omex - scrap dealer
- o Hut-pus - hotel and holiday/catering services
- o Belmer - maintenance of plant & equipment
- o Metalodlew - large castings
- o Krakodlew - ferrous foundry
- o PTS - haulage

In each case, HTS has retained a significant but minority equity stake.

AII.3.6 All of the companies spun-off by HTS have been structured in a similar manner. All have been privatised by means of employee ownership. In order for this to be accomplished, given the limited capital-raising capacity of the employees, the assets of each business have been leased by HTS to a newly-created limited liability entity (either S.A. or, in some cases, Sp z OO), majority-owned by the employees. The equity retained by HTS varies, from 40%-49%. In all cases HTS has only retained minority ownership.





AII.3.7 As a consequence of the way in which the capital was structured, each spun-off company started life "thinly capitalised"; that is, with relatively low capital and a high level of (off-balance sheet) borrowing via the leasing arrangement. This starting structure created a high level of both balance sheet and income gearing during the first period of independent existence. The business risk created by the high level of gearing was further augmented by the fact that at the date of spin-off, all the spun off companies were highly dependent on HTS in a commercial sense. HTS was either their main (or only) customer or supplier.

AII.3.8 Despite the lack of capital, and the dependency mentioned above, none of the spun-off companies has failed. All of the larger companies have a record of progressive growth in profits, and a lessening of the dependence on HTS (as a proportion of total sales). Redundancies have been negligible.

AII.3.9 Some 3 years after spin-off, the largest of the companies listed above have reached a position where they are able to discuss their investment programmes with outside commercial sources of finance. Although no transaction has yet taken place, Z_omex, PMO and Stalprodukt have all been approached recently by institutional equity investors. Stalprodukt, the largest of the spin-offs, is preparing for a public share issue to raise funds of USD20-30 million and a listing on the Warsaw Stock Exchange by the middle of next year.

AII.3.10 While the spun-off businesses are becoming attractive to financial investors, the core business of HTS is attractive to steel producers, and discussions are being held with a number of European and far Eastern companies.

AII.4 Social and employee aspects-

AII.4.1 One of the major objectives of HTS management during the process of restructuring was and continues to be the avoidance of industrial unrest. In the absence of any social safety-net funding support from central government, it was impossible to impose any substantial headcount reduction programmes. In the event, the management pledged that there would not be any wholesale redundancies, but that HTS would run, in parallel with the streamlining of its steelmaking business, a job creation programme.

AII.4.2 The job creation programme consists substantially of the attraction of new businesses into the Nowa Huta area, where the there exists both the infrastructure and labour force to service incoming industry. A special unit (Kraków-East Development Agency) was set up to handle the deployment of surplus assets for this purpose, and to market this area via trade and commercial attaches etc.. Recently, this Agency has commenced marketing a new business park set up on the site of certain old works areas of HTS.

AII.4.3 So far, there has not been any industrial unrest at HTS. However, the scale of the job reductions needed in the coming years (17,540 employees currently, reducing to less than 10,000 over the next 3 or 4 years) make this a major problem area, particularly given the absence of central government support.

ATTACHMENT III:

OVERVIEW OF HUTA KATOWICE

AIII.1 Production at Huta Katowice ("HK")-
Total 1995 steel product sales were 4,774,000 tonnes. Sales in 1995 were 3,300 million Pln, up from 2,400 million in 1994.

AIII.1.1 Fully integrated production takes place at one site just outside Katowice, although there is another significant production site owned by HK nearby, but physically separate (called Huta Bankowa). The works were constructed in the period 1972-1976 on a greenfield site near Katowice. The steel output is capacity is currently planned to be (when all proposed construction is completed) 1,700 thousand tonnes pa of long products, about 2,000 thousand tonnes pa of strip steel in coils and about 950 thousand tonnes or thereabouts of continuously cast ingots.

AIII.1.2 Key raw materials are sourced from the Ukraine (iron ore) and from local mines (coal for coking). There is a wholly-owned subsidiary which sources and supplies most of the scrap steel needed for steelmaking. Limestone is sourced from nearby mines in the Kielce area. Coke is made on site in ten wet-quench coking batteries.

AIII.1.3 The steelmaking production flow is mostly traditional in nature. 3 blast furnaces of 3,200 cu. metres capacity are fed by three sintering machines. The blast furnaces feed 2 steel-making converters (of 350 tones capacity), with a newly commissioned continuous caster now running on the third. Thereafter, there is a blooming mill, a billets continuous mill, and a medium and heavy mill department.

AIII.2 Investment needs-

AIII.2.1 The investment (modernisation) programme for HK is a serious future commitment for the steelworks, and for any incoming investor. We were not informed of the proporsed capital spends, but the value of the investment required must be very substantial, as it envisages the installation of a second and third continuous casting machine (the second is currently under way), and the installation of integrated sheet casting and rolling equipment to produce flats (strip steel).

AIII.2.2 To the previous plant and equipment spends should be added amounts required to provide for environmental control equipment. In particular, the coking activity in Zdzieszowice requires upgrading.

AIII.2.3 Most interestingly, in 1995, HK formed Rudoport SA in order to build a new iron ore terminal in Gda_sk. This is necessary, in order to allow large vessels access to the port, to make supplies of Swedish or Brazilian ore (these ores are 3-4 times, or more, ferrous than Russian ore). The port of Gda_sk has a good rail link to the Katowice region, which makes this form of transportation feasible.

AIII.2.4 As with HTS, the amount of spend planned cannot be funded from cashflow internally generated by HK over the relevant period.

AIII.3 Restructuring and Privatization at HK-

AIII.3.1 Huta im T Sendzimira is one of the largest Polish State-Owned Enterprises in the manufacturing field and is the largest steelworks in Poland. Ignoring consolidated coal-mines, it is the largest single employer in the Katowice region, with a payroll of 22,690 and further significant employment in dependent (mostly, majority-owned) subsidiaries.

AIII.3.2 The enterprise is an SA, operating under the rules set out in the Polish commercial code. thus, there is a Chief Executive, Mr B Ko_omyjski and a supervisory board. As noted earlier, this form of governance strengthens the ability of management to manage. There is no founding organ, and the State Treasury is represented by the Ministry of the Treasury, although because of its significance, the enterprise is subject to the control of the Council of Ministers. The company was commercialized (converted from a PP to an SA) in June 1991.

AIII.3.3 In the mid 1980s, HK was a vertically integrated steelmill, with a typical command economy structure. It had its own hospital, hotels, transport, toolshops, maintenance and rework facilities and so on.

AIII.3.4 HK has relatively recently just commenced a programme of restructuring, which includes the retraining of top management, the spin-off of non-core businesses and the redeployment of surplus assets. This restructuring helped turn the 1994 net loss of 25 million Pln, into the 1995 net profit of approximately 29 million Pln. This programme is similar to the more advanced HTS model. To date, HK has not spun-off into private hands any companies, although some have now been hived-off ready for external participation.

AIII.3.5 A major achievement has been the gaining in 1995 of ISO9002 certification in connection with the production of billets and hot rolled products generally.

AIII.4 Social and employee aspects-

AIII.4.1 HK has had a number of strikes, including one serious stoppage. One of the major objectives of HK management during the process of restructuring is the avoidance of industrial unrest. In the absence of any social safety-net funding support from central government, it is impossible to impose any substantial headcount reduction programmes. Recent developments in the area (the contract for _l_sk, and the creation of economic zones to attract General Motors and others to the area) have been helpful in abating worker anxiety. Nevertheless, the managements' view is that a guarantee of the absence of wholesale redundancies is unavoidable. Thus in common with others, HK has to run, in parallel with the streamlining of its steelmaking business, a job creation programme.

AIII.4.2 The job creation programme consists substantially of the attraction of new businesses into the Katowice/D_browa/Gliwice area, where the there exists both the infrastructure and labour force to service incoming industry. A special unit has been set up at HK to handle this work (Grupa Kapita_owa).

ATTACHMENT IV:

OVERVIEW OF STALPRODUCT & FLORIAN

STALPRODUCT

ASIV.1 General information-

ASIV.1.1 Stalprodukt is a joint stock company formed in January 1992 as a spin-off from HTS, owned 40% by HTS. The remainder of the shares are owned (mostly in small, uniform stakes) by some 2,000 individuals who were employees as at the date of formation.

ASIV.1.2 Stalprodukt is located entirely on one site at Bochnia, about 40 kilometers east of the HTS steelworks at Nowa Huta. The site was originally leased from HTS, but the purchase of the site for cash raised via bank loans has now been completed and it is held in perpetual usefruct.

ASIV.1.3 1995 turnover aggregated 300 million Pln. The workforce amounts to 2,239 individuals, and has fallen slightly since privatization.

ASIV.2 Market position-

ASIV.2.1 Stalprodukt makes grain-orientated electrosteels and shaped steel sections. The range of products includes over 300 types of cold rolled sections, including closed section welded square and rectangular structural tubing, half closed sections and open sections, A & B motorway barriers, channels and others.

ASIV.2.2 Sales are made into the Polish market and to export markets. Exports are significant, and in 1995 accounted for just over 29% of sales. Most exports are to European markets, but recent sales have been made as far afield as Japan.

ASIV.2.3 Stalprodukt is the only Polish producer of electrosteels. Because of tariff barriers and because of transportation costs, import competition is limited. Management indicated that they had a dominant position in the Polish market, supplying both domestic (local) and foreign (local) customers. By way of contrast, steel sections, whether motorway barriers or others, are subject to strong competition from many indigenous producers.

ASIV.2.4 There are no sales to HTS. The HTS relationship is via the supply link (see ASIV.3.1).

ASIV.2.5 Sales of electrosteels are made directly to OEM manufacturers. Exports are also made directly to the final customer without the use of any intermediaries. Stalexport is no longer involved in any way. Sections are sold via the established distributor network.

ASIV.3 Production-

ASIV.3.1 Raw material (steel coil) is principally sourced from HTS at Nowa Huta (40 kilometers distant). Until recently, HTS was the only source. Over the last eighteen months, Stalprodukt has trial tested alternative sources of coil, and CEFTA sources are currently becoming price attractive, due to the reduction of customs duties and tariffs. As a result, there is currently a small amount of dual-sourcing and the critical dependence on HTS supplies and pricing policy is likely to be reduced. The security of supply of steel coil from HTS is currently covered by a long-term supply agreement with HTS, and there are no other significant raw materials.

ASIV.3.2 Steel coil is cold rolled and appropriately treated to produce electrosteel coil of various sizes. Sections are produced on normal bending/shaping roller presses. Stalprodukt gained ISO9002 certification in May 1996. Environmental aspects of the production process comply with current regulations, and no upgrades are needed in this area.

ASIV.3.3 Stalprodukt's major intended new product development is the processing of specialist steels, including stainless and acid-resist. This is a niche situation in the domestic Polish marketplace, as currently there are no Polish producers, and all such steel has to be imported (a certain amount of narrow steel strip is produced in Poland from imported coil). The intention is to produce up to 1500 mm and 0.4mm gauge specialist steels with full surface finishing treatment. We were informed that the cost of the related investment has been estimated as about USD50 million over the next two years.

ASIV.3.4 Stalprodukt has all but completed its buy-out of assets from HTS, and its immediate investments needs approximate the USD50 million specialist steel line referred to above.

ASIV.4 Financial performance-

ASIV.4.1 Profit and loss results history and expectations for the current year are as follows (000,000 Pln)-

	--------actual-------			budget
	1993	1994	1995	1996
Sales	118.6	169.4	300.8	420

Net profit	5.9	10.2	19.0*	20.0*

* according to management, the real progression here is smoother, but the 1995 result is distorted (profit increased) by an investment tax relief credit

ASIV.4.2 Despite the progressive purchase of its fixed assets from HTS, Stalprodukt has improving liquidity. Liquidity ratios provided by management are as follows-

	1993	1994	1995
Current ratio	1.5	1.8	2.4
Quick ratio	0.8	1.2	1.3

Although these ratios reveal an increasing level of stock holding, they also show an adequate and increasing level of working capital liquidity.

ASIV.4.3 Earnings per share trends have been good (1995 - 86.2 Pln/share as compared to 52.2 Pln/adjusted share in 1994). There was a rights issue of shares in 1995.

ASIV.4.4 Stalprodukt has substantial investment needs, approximating 140 million Pln (USD50 million) over the next two years (1997/98). Internal cashflow is substantial, and capable of generating an estimated 30 million Pln per annum. However, this still leaves a substantial shortfall.

ASIV.4.5 Management plans to raise the required funding as follows (000,000 Pln):

Early 1997 - public issue of shares on Warsaw Stock Exchange	60
Late 1997 - bank borrowings (estimate)	50
Internal (surplus to working capital needs)	30
Total programme	140

ASIV.5 Contacts with strategic investors-

Stalproduct has achieved control of the Polish domestic marketplace and is vigorously attacking the export marketplace. It has achieved international quality and technical standards. It can multiple source its raw material from Polish producers or import sources, whichever is better, and can access funding from Polish capital markets. For these reasons, it does not need a strategic trade partner.

However, there is no doubt that Stalprodukt is a particularly attractive investment target for trade investors. It has a dominant market share in Poland, and is an excellent vehicle for market entry, both in the existing electrosteels sector, as well as in the potential specialist steels market segment. Stalproduct has been contacted by a number of European companies present in this sector, including British Steel, Rautaruukki, Arbed and a number of others.

Management have indictated that they are aware that a trade link-up may eventually be sensible, for financial reaons, and to create clout in the international marketplace, but consider that a prior flotation on the Warsaw Stock Exchange will enable them to implement the technology developments which Stalprodukt needs, as well as providing a market valuation for the company as a whole.

HUTA FLORIAN

AFIV.1 General information-

AFIV.1.1 Huta Florian ("Florian") is a *przedsi_biorstwo pa_stwowe* ("PP"), a State-Owned Company, wholly owned by the State Treasury of Poland.

AFIV.1.2 Florian is located entirely on one site at _wi_toch_owice, within the Katowice/Bytom/Gliwice conurbation in South-West Poland.

AFIV.1.3 1995 turnover aggregated 386 million Pln. The workforce amounts to 2,700 individuals.

AFIV.2 Market position-

AFIV.2.1 Florian makes galvanised and organic coated (painted) steel sheet, cold rolled strip steel and hot rolled rods and bars. The range of products includes profiled coated sheet and insulated fascia panels.

AFIV.2.2 Sales are made mainly into the Polish market. Export sales are modest. Most exports are to European markets.

AFIV.2.3 Florian is the only Polish producer of painted sheet steel and profiled roofing, and one of two domestic producers of wide galvanised sheet steel (the other is HTS).Because of tariff barriers and because of transportation costs, import competition is disadvantaged at present. However, Management indicated that they did not consider that they had a dominant position in the Polish market, due to the large number of foreign competitors supplying both galvanised and painted products (Rautaruukki, Lindab, Eko-Stahl).

Florian also produces rods and bars, and here there is a plethora of competing Polish producers (HTS, Cedler, and many others).

AFIV.2.4 There are no sales to HTS. The HTS relationship is via the supply link (see AFIV.3.1).

AFIV.2.5 Sales of coated sheet steel are made directly to OEM manufacturers. Florian is developing its own captive (part-owned) distribution network. Exports are also made directly to the final customer without the use of any intermediaries. Stalexport is not involved.

AFIV.3 Production-

Production is segmented into cold rolling - flat sheet steel processing, coating and profiling, and hot rolling (rods and bars).

AFIV.3.1 Raw material for the cold rolling side (steel coil) is principally sourced from HTS at Nowa Huta (80 kilometers distant). Until recently, HTS was the only source. Over the last 12-18 months, Florian has trial tested alternative sources of coil, and CEFTA sources are currently becoming price attractive, due to the reduction of customs duties and tariffs. As a result, the key dependence on HTS supplies and pricing policy is likely to be reduced.

AFIV.3.2 Steel coil is cold rolled and appropriately treated to produce coil suitable for coating (galvanising) and painting. Some coil is slit and sold in the black.

AFIV.3.3 Hot rolling is physically separate from the cold rolling operations, and until recently, included the production of steel. Currently, the steelworks operation has been closed (without loss of jobs, which have been transferred elsewhere), and discussions are being held with aview to integrating the hot operations with those of another steelworks (possibly Huta Katowice). The motivation for this is the need to reduce costs in order to remain competitive in this price-competitive product area.

AFIV.3.4 Florian's major new products are the recently introduced profiled roofing sheet and the range of insulated fascia panels. Both of thee are intended for the Polish marketplace, where due to a lack of domestic product availability, imports have gained a major bridgehead. In the medium term, Florian intends to upgrade its galvanising capacity in order to produce for the motor industry. In this connection, it should be noted that the GM factory will be located close by, in Gliwice.

AFIV.3.5 Florian has substantial investment needs, linked to the marketplace opportunities present in the on-processing of steel sheet, and in the motor industry sector (see AFIV.4.3).

AFIV.3.6 Florian also has substantial social assets which it has not yet divested. These include 1,190 apartments in the immediate locality. There is no information to hand on the cost of maintaining these social assets.

AFIV.4 Financial performance-

AFIV.4.1 Profit and loss results history and expectations for the current year are as follows (000,000 Pln)-

	--------actual------			budget
	1993	1994	1995	1996
Sales	n/a	276	386	368
Net profit	n/a	3.9	28.8	22.2

AFIV.4.2 Following the very good results of 1994, Florian's liquidity has much improved. Liquidity ratios provided by Management are as follows-

	1993	1994	1995
Current ratio	1.4	1.3	2.5
Quick ratio	0.9	0.8	1.4

However, the proposed large capital expenditure programme is likely to erode the liquidity position of the enterprise (being a PP, it is only able to source additional funds via bank loans and retained profits - it cannot issue more equity).

AFIV.4.3 Florian has substantial investment needs, approximating 170 million Pln (USD60 million) over the next three years (1997/99). Internal cashflow, estimated at 20 million Pln per annum, is insufficient to fund this expenditure and leaves a substantial shortfall which cannot be met from normal commercial borrowings.

AFIV.4.4 Managements' current plans are to raise the initial amounts required to commence the capital investment programme from borrowings. However, this is unlikely to safely fund the full amount required. At the enterprise, consideration is also being given to joint-venturing the galvanising operation with a financial partner, which could provide the full amount of funding needed. The final solution has not yet been decided.

AFIV.5 Privatization and restructuring issues-

AFIV.5.1 Florian has achieved good penetration of the domestic Polish marketplace and is vigorously developing new import-substitute products for this marketplace. It can multiple source its raw material from Polish producers or import sources and has closed down its ecologically unsafe and economically unprofitable steel production. Its marketplace direction is sound, and its current financial condition is good. For these reasons, it does not need a strategic trade partner.

AFIV.5.2 However, because of its PP status, Florian cannot access funding from Polish capital markets. This is likely to severely restrict Florian's ability to invest in promising market/production developments, and to compete successfully. For purposes of raising capital, Florian needs a strategic financial partner. Such a partner might be persuaded to joint-venture part of the enterprise as part of an in-enterprise restructuring move, or to participate in the privatization of the whole of the enterprise. The latter is a much slower process than the former.

AFIV.5.3 However, there is no doubt that Florian is an attractive investment target for trade investors. It has a good and growing market share in Poland, and is an excellent vehicle for market entry, both in the existing sheet steels sector, as well as in the potential galvanised motor industry steels market segment. Florian has been contacted by a number of European companies present in this sector, including British Steel, Rautaruukki, and a number of others.

AFIV.5.4 Management have indictated that they are aware that a trade link-up may eventually be sensible. However, they consider that the current idea of combining Florian with HTS will create a new unwieldy and uncompetitive monopoly entity in the galvanised steel sector, which will be driven by HTS and serve HTS's purposes. They would rather compete with HTS than be part of that monopoly, irrespective of the ultimate ownership.